May 13, 2011

Jennifer J. Johnson, Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, NW
Washington, D.C. 20551

Robert E. Feldman, Executive Secretary
Attention: Comments
Federal Deposit Insurance Corporation
550 17th Street, NW
Washington, D.C. 20429

Re: Prohibition Against Payment of Interest on Demand Deposits (Regulations D, Q, and DD; Fed Docket No. R-1413; Interest on Deposits; Deposits Insurance Coverage (FDIC RIN 3064-AD78)

Dear Ms. Johnson and Mr. Feldman:

The Independent Community Bankers of America[1] (ICBA) welcomes the opportunity to comment on (1) the Federal Reserve's proposal to repeal Regulation Q, the Prohibition Against Payment of Interest on Demand Deposits, and (2) the proposal by the FDIC to rescind regulations that have implemented the prohibition on paying interest on demand deposits. Both agencies are taking these actions because the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act") repealed the statutory authority to prohibit the payment of interest on demand deposits effective on July 21, 2011.

[1] The Independent Community Bankers of America represents nearly 5,000 community banks of all sizes and charter types throughout the United States and is dedicated exclusively to representing the interests of the community banking industry and the communities and customers we serve. ICBA aggregates the power of its members to provide a voice for community banking interests in Washington, resources to enhance community bank education and marketability, and profitability options to help community banks compete in an ever changing marketplace.

With nearly 5,000 members, representing more than 20,000 locations nationwide and employing nearly 300,000 Americans, ICBA members hold $1 trillion in assets, $800 billion in deposits, and $700 billion in loans to consumers, small businesses and the agricultural community. For more information, visit ICBA's website at www.icba.org.

**Background**

The Federal Reserve Board issued Regulation Q in 1933 as part of implementing the Glass-Steagall Act. In the past, Regulation Q also contained provisions that regulated the rates of interest payable on various types of interest-bearing deposits. The Depository Institutions Deregulation Act of 1982 phased out these statutory interest rate limitations effective in March 1986. After that time, Regulation Q consisted primarily of provisions relating to the prohibition of interest on demand deposits for member banks. The FDIC regulations at 12 CFR Part 329 are similar to Regulation Q and applied the prohibition to state nonmember banks.

The bill to repeal Regulation Q was introduced in 2009 by Rep. Scott Murphy (D-NY) under the title *The Business Checking Fairness Act* and was eventually inserted as an amendment to the Dodd-Frank Act. Neither the House nor the Senate debated at length the provision that eventually became Section 627 of the Dodd-Frank Act and there never was a serious attempt to assess its impact on the banking industry. Section 627 repeals Section 19(i) of the Federal Reserve Act, effective one year from the date of enactment. Accordingly, the Federal Reserve Board will no longer have statutory authority to promulgate Regulation Q and the FDIC will no longer have authority to issue its regulations prohibiting the payment of interest on demand deposits effective July 21, 2011.

**ICBA's Position**

**ICBA supports an indefinite postponement of the proposed rescission of Regulation Q and those FDIC regulations that prohibit the payment of interest on demand deposits until the agencies are able to study the safety and soundness consequences of allowing these regulations to expire.** We believe that the repeal of Regulation Q will have serious implications for the balance sheets and income statements of many community banks. It will significantly increase their funding costs and squeeze the margins of those community banks that are unable to pass along the costs to their depositors and loan customers. Competition from large banks will also force community banks to pay interest on business accounts, which will disqualify those accounts from temporary unlimited FDIC coverage for non-interest bearing transaction accounts. This will undermine a program intended to offset the funding advantage of the too-big-to-fail banks, which has been heightened due to the financial crisis.

**Besides having a detrimental effect on the balance sheets of community banks, ICBA is also concerned that the repeal of Regulation Q will result in increased deposit volatility.** Businesses will be under great pressure to seek the highest return on their deposits resulting in bidding wars for business deposits among banks. They will be less willing to leave money in a no or low interest demand deposit account just for the benefit of receiving a discounted or free banking service. Business deposits may become so volatile that they may expose banks to potential liquidity problems.

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**ICBA's Survey on Repeal of Regulation Q**

During the month of April, 2011, ICBA conducted a survey of it members to determine the potential impact of the repeal of Regulation Q. Approximately 460 community bankers responded to the survey representing banks from almost every state. In response to a question about the impact of the repeal of Regulation Q, almost 64% of respondents said that it would have significant implications for their bank's income. Asked specifically about how the bank's income would be impacted, more than 55% said it would have up to a 10% adverse impact and more than 20% said it would have a greater than 10% adverse impact on earnings.

Almost 80% of the community bankers who responded also said that the repeal of Regulation Q would make deposit liabilities more interest rate sensitive and therefore more volatile. An overwhelming majority of bankers concluded that community banks will have higher interest rate expense and would find it more difficult to attract deposits as a result of the repeal of Regulation Q.

As one community banker said in response to the survey:

> "The repeal of Regulation Q is one more bullet in the heart of community banks. The large regionals in our area will likely launch a campaign to convince our commercial customers how wonderful it would be for them if their deposits were in the large regional bank, which will force the community banks to respond as best they can with their limited advertising budgets. The actual cost of paying interest on these accounts will not be significant now with rates so low, but when the rates begin to move up, and they most certainly will, these accounts will become very rate sensitive and the interest expense will grow very quickly. Its difficult enough for the little fish to swim with the sharks now, this will only make it that much more difficult. With this and all the other changes community bankers everywhere are beginning to look for ways to get out. I have never seen such a degree of negative attitudes about the future of community banking.

Another community banker responded by saying:

> The repeal of Regulation Q will increase the volatility of deposits to such an extreme extent that it could destabilize the entire banking industry, leading to hundreds or thousands of bank failures, while contributing to the growth of the too-big-to-fail megabanks (the only ones who will be able to offer "competitive" interest rates on demand deposits.) This will further destabilize the economy of the U.S. and the rest of the planet. This decision should be reversed before it is too late.

Community banks in rural areas pointed out that they will be particularly hard hit by the repeal of Regulation Q since loan demand is stagnant and it will be hard to pass along the higher funding costs. As one rural banker put it, "Liquidity will have a greater price because the marketplace will dictate interest on these deposits to maintain a relationship. However, in rural areas we have a surplus of liquidity, our loan/deposit ratios are down, loan demand is slack currently and our projection is that our costs will go up without an offsetting income benefit."

Community bankers that responded to the survey also said they would have difficulty taking advantage of the FDIC's temporary unlimited FDIC coverage for non-interest bearing transaction accounts, since a condition to participation in that program is that banks are prohibited from paying any interest on their demand deposits. As one banker said, the repeal of Regulation Q "is counter to the intentions of providing full insurance on non-interest bearing accounts in order to protect deposit stability. It will lead to more volatility as banks now compete on rate and attract non-core deposits that are only there for the rate rather than the full relationship, including loan pricing and cash management services."

**Greater Costs to Businesses and Increased Concentration of Financial Assets**

The repeal of Regulation Q will also have broader economic consequences. Large corporations that are now flush with cash will significantly increase their bank deposits as evidenced by the experiences of other countries. In France for example, when the prohibition on interest payments for corporate checking accounts was repealed, the percentage of bank deposits increased dramatically. Funds will shift from money market mutual funds to banks. ICBA expects that the major beneficiaries of this increase in commercial deposits from large corporations and the transfer of money from mutual funds will be the megabanks, and that this will further increase the concentration of bank assets and exacerbate the problem of too-big-to-fail.

Furthermore, banks will be forced to offset their higher funding costs with higher service fees and loan rates. Currently, many commercial products and services are partially subsidized by the spread income the bank earns on the deposits that the service generates. To offset the lower spreads, banks will increase the costs of the products and services or eliminate them altogether. Business customers that currently enjoy free checking, lockbox, and other services will be charged for such services. Consumers also will see new charges for bank services as banks seek to cover their increased funding costs.

An increase in deposits and need for revenues could pressure banks to expand their lending activities at a time when loan demand from creditworthy borrowers is weak. Banks may find it challenging to deploy increased deposits in a safe and sound manner.

For those banks located in areas where loan demand is strong and can pass along the costs to their loan customers, community banks will increase their loan rates. The increases in credit costs to commercial customers will be significant if large portions of deposits are converted to interest-bearing accounts. For banks in areas where loan demand is not so strong, community banks will be forced to absorb the higher funding costs, further squeezing their already thin margins.

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**ICBA Urges the Federal Reserve and the FDIC to Postpone the Rescission of Regulation Q Due to Safety and Soundness Concerns**

**ICBA urges the Federal Reserve to indefinitely postpone the rescission of Regulation Q and the FDIC to postpone their regulations prohibiting the payment of interest on demand deposits so that the agencies can further study the implications for community banks' balance sheets and income statements of repealing Regulation Q.** Otherwise, we fear that the sudden repeal of Regulation Q on July 21st will significantly impair the ability of community banks to attract commercial deposits and make loans to their communities. We are also concerned that excessive interest rate competition could be harmful to overall banking stability and the safety and soundness of banks.

We propose that the study take at least a year and that it look at all aspects of Regulation Q including the potential impact of its repeal not only on balance sheets and income statements of banks but also on bank liquidity, risk, and the potential for further concentration of financial assets. The agencies should also review whether competition of business customers would result in increased volatility of deposits and excessive competition deleterious to banking stability. **ICBA notes that even though the banking agencies may not have the legal authority to issue a regulation prohibiting the payment of interest on demand deposits, they still have the authority to issue a policy statement that would prevent all banks from paying interest on deposits until the agencies believe it is safe and sound to do so or until a study is completed.**

In lieu of repealing Regulation Q, the agencies should also review again the idea of amending Regulation D to exempt from the definition of a "demand deposit" a money market deposit account or MMDA allowing up to 24 transactions a month for entities not eligible for NOW accounts. This will allow community banks to sweep daily between a business's 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.

**Conclusion**

ICBA strongly urges the Federal Reserve and the FDIC to indefinitely postpone the proposed rescission of Regulation Q and those FDIC regulations that prohibit the payment of interest on demand deposits until the agencies are able to study the safety and soundness consequences of allowing these regulations to expire. The repeal of Regulation Q will have serious implications for the balance sheets and income statements of many community banks and the stability of the banking system. Business deposits will become so volatile that they may expose banks to potential liquidity problems.

ICBA's survey of community banks conducted last month indicate that community banks will be seriously impacted by the repeal of Regulation Q. Although some rural banks indicated that they may not be impacted by the repeal of Regulation Q because they don't have that many corporate customers, other rural banks with business customers indicated that they will be particularly affected because they will be unable to pass along the increased funding costs to their loan customers. Banks located in urban and suburban areas anticipate increased competition for deposits from large banks. A number of banks also complained that competition from large banks will also force them to pay interest on business accounts, which will disqualify those accounts from temporary unlimited FDIC coverage for non-interest bearing transaction accounts. This will undermine a program intended to offset the funding advantage of the too-big-to-fail banks.

The repeal of Regulation Q will have broad economic consequences. ICBA believes the major beneficiaries will be the megabanks, and that this will further increase the concentration of bank assets and exacerbate too-big-to-fail. Furthermore, banks will be forced to offset their higher funding costs with higher service fees and loan rates.

Even though the banking agencies may not have the legal authority to issue a regulation prohibiting the payment of interest on demand deposits, they still have the authority to issue a policy statement that would prevent all banks from paying interest on deposits until the agencies believe it is safe and sound to do so or until a study is completed. ICBA would propose that the study take at least a year and that it look at all aspects of Regulation Q including the potential impact of its repeal not only on balance sheets and income statements of banks but also on bank liquidity, risk sensitivity, and the potential for further concentration of financial assets. In lieu of repealing Regulation Q, the agencies should also review again the idea of amending Regulation D to exempt from the definition of a "demand deposit" a money market deposit account or MMDA allowing up to 24 transactions a month for entities not eligible for NOW accounts.

ICBA appreciates the opportunity to comment on the Federal Reserve's proposal to repeal Regulation Q and the proposal by the FDIC to rescind regulations that have implemented the prohibition on paying interest on demand deposits. If you have any questions about our letter, please do not hesitate to contact me at 202-659-8111 or Chris.Cole@icba.org.

Sincerely,
/s/ Christopher Cole

Christopher Cole
Senior Vice President and Senior Regulatory Counsel



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