CONGRESSIONAL BUDGET OFFICE
COST ESTIMATE

February 25, 1999

Financial Regulatory Relief and Economic Efficiency Act of 1999

As ordered reported by the Senate Committee on Banking, Housing, and Urban Affairs on February 11, 1999

SUMMARY

The Financial Regulatory Relief and Economic Efficiency Act of 1999 (FRREE) would make numerous changes to the relationship between financial institutions and the federal agencies that are responsible for regulatory and monetary policy. Most significantly, the bill would permit the Federal Reserve System to pay interest on reserves held on deposit at the Federal Reserve, and it would repeal the provision of law that prohibits depository institutions from paying interest on commercial demand deposits. The bill also would eliminate the requirement that the Federal Deposit Insurance Corporation (FDIC) retain a "special reserve" for the Savings Association Insurance Fund (SAIF), and it would raise the pay of the Chairman and six other members of the Board of Governors of the Federal Reserve System.

CBO estimates that the bill would reduce federal revenues by $661 million over the period from 2000 through 2004. Consequently, pay-as-you-go procedures would apply to the legislation. The provisions regarding interest on reserves and interest on commercial demand deposits account for the budgetary effect. The provisions to remove the requirement that the FDIC maintain a separate reserve balance for the SAIF and to raise the pay for the Board of Governors of the Federal Reserve System are estimated to have an insignificant budgetary effect. CBO also estimates that no significant budgetary effects would result from the remaining provisions, which largely clarify or streamline certain rules and procedures.

FRREE contains no intergovernmental mandates as defined in the Unfunded Mandates Reform Act (UMRA) and would have no significant effects on the budgets of state, local, or tribal governments. FRREE contains no private-sector mandates as defined by UMRA. The bill would change existing laws in ways that could lower the costs to depository institutions of complying with existing federal requirements.

ESTIMATED COST TO THE FEDERAL GOVERNMENT

The estimated budgetary impact of FRREE is shown in the following table.

	By Fiscal Year, in Millions of Dollars					
	2000	2001	2002	2003	2004	2005-2009
CHANGES IN REVENUES [a]						
Interest on Required Reserves and Business Demand Deposits	-214	-161	-91	-95	-100	-571

a. The bill would also affect direct spending, but by amounts of less than $500,000 a year.

The major budgetary effect of FRREE would be a decrease in the payment of profits from the Federal Reserve System to the Treasury. The Federal Reserve remits its profits to the Treasury, and those payments are classified as governmental receipts, or revenue, in the federal budget. Any additional income or costs to the Federal Reserve, therefore, can affect the federal budget. The Federal Reserve's largest source of income is interest from its holdings of Treasury securities. In effect, the Federal Reserve invests in Treasury securities the reserve balances and issues of currency that comprise the bulk of its liabilities. Since the Federal Reserve pays no interest on reserves or currency, and the Treasury Department pays the Federal Reserve interest on its security holdings, the Federal Reserve earns profits.

By allowing the Federal Reserve to pay interest on reserves, the bill, according to CBO's analysis, would reduce the Federal Reserve's profits and thereby reduce federal revenues by $661 million over the period from 2000 to 2004. The estimate includes an anticipated response by depository institutions and depositors that would increase the amount of demand deposits and, therefore, required reserves. CBO estimates that this response would reduce, but not eliminate, the expected loss in federal revenues.

BASIS OF ESTIMATE

The estimates assume that the provisions would become effective at the beginning of fiscal year 2000, unless otherwise specified.

Paying Interest on Reserve Balances

Paying interest on the reserves that depository institutions hold on deposit at the Federal Reserve ("required and excess reserve balances") would shift profits from the Federal Reserve to depository institutions and reduce governmental receipts. The budgetary effect can be divided into two components. First, the bill would cause the Federal Reserve to pay interest on the level of its required reserve balances expected under current law, reducing its net income and, therefore, governmental receipts. The reduced receipts would be offset only partially by increased corporate income tax receipts from the higher profits of depository institutions. Second, the payment of interest on reserves held at the Federal Reserve and on commercial demand deposits held at depository institutions would cause demand balances at depository institutions to increase. That increase would raise the level of reserve balances at the Federal Reserve, which would invest them at a rate higher than it would pay on them. This change in projected reserves would increase governmental receipts on net, but would only partially offset the loss caused by the payment of interest on reserves projected under current law.

Revenue Effect of Allowing Interest
on Reserve Balances
(By Fiscal Year, in Millions of Dollars)

	2000	2001	2002	2003	2004	2005-2009
			CHANGES IN REVENUES			
Federal Reserve Revenue	-285	-215	-121	-127	-133	-761
Income Tax Revenue	71	54	30	32	33	190
Total, Revenue Effect	-214	-161	-91	-95	-100	-571

Interest Payments on Reserves Projected Under Current Law. Because depository institutions currently do not earn a return on reserve balances, they have an incentive to minimize such balances. Required reserve balances measured almost $30 billion at the end of 1993, but have since fallen sharply to about $8 billion today. The widely-reported expansion of consumer sweep accounts has caused this decline. In typical sweep accounts, banks shift their depositors' funds from demand deposits, against which reserves are required, into other depository accounts, against which no reserves are required. The banks shift the funds back to the demand deposit accounts the next business day, or when needed by the depositor. Sweep accounts for business demand deposits have existed in various forms since the early 1970s and have had the same effect of reducing required reserves. Recent advances in computer technology have now made the shifting of funds feasible for many consumer ("retail") accounts as well. Under current law, CBO expects the expansion of retail sweep accounts to continue and, based on its January 1999 baseline, required reserve balances to decline further to about $5.0 billion by 2002. Thereafter, CBO projects them to rise gradually with growth in the economy.

FRREE would permit the Federal Reserve to pay interest on reserve balances. The Federal Reserve would be allowed to choose the interest rate, although the rate chosen could not exceed the general level of short-term interest rates. The Federal Reserve has indicated that, given the authority, it would pay interest on <u>required</u> reserve balances and it would choose an interest rate near the key short-term rate, the federal funds rate. The rate likely would be roughly 10 basis points lower than the federal funds rate to account for the lack of risk. The Federal Reserve has indicated, however, that it would choose not to pay interest on <u>excess</u> reserves unless required reserve balances fell to such a low level that interest on excess reserves was needed in order to build reserves. CBO assumes, therefore, that the Federal Reserve would pay interest only on required reserves, at a rate near the federal funds rate. Based on its January 1999 baseline assumptions, CBO projects the federal funds rate to average about 4.75 percent during the 10-year period from 2000 through 2009. CBO assumes that the payment of interest on reserves would start early in fiscal year 2000. CBO projects that the bill would cause the Federal Reserve to pay interest to depository institutions of about $325 million in 2000 on the $7.0 billion of required reserve balances expected under current law. Such interest payments would decline to about $280 million in 2001 and $230 million in 2002 because of lower reserve balances. Over the period from 2000 through 2004, such interest payments would total about $1.3 billion. Those payments would reduce the profits of the Federal Reserve--and thus its payment to the Treasury--by the same amount.

Because receipts of interest by depository institutions presumably would increase their profits by the same amount that the Federal Reserve's profits declined, overall profits in the economy would remain unchanged. Assuming that depository institutions face a marginal tax rate on corporate income of 25 percent, we estimate that corporate income tax receipts would increase by about $80 million in 2000 and $330 million through 2004 as a result of the additional interest income. That increase in receipts would offset one-quarter of the reduction in governmental receipts from reduced Federal Reserve profits. Thus, the net revenue loss to the federal government from the interest payments with no change in projected reserves would be about $245 million in fiscal year 2000 and approximately $1.0 billion over the period from 2000 through 2004.

It is possible that, instead of retaining the additional interest income, depository institutions would pass some of the increased profits through to their business and consumer customers by raising interest rates on deposits or lowering rates on loans. If a complete passthrough did occur, then the customers--not the depository institutions--would accrue the income and pay the additional taxes. The increase in income tax revenues would be roughly similar to that estimated without such a passthrough assumption.

Projected Impact of the Bill on the Volume of Reserves. If the Federal Reserve paid interest on required reserve balances and depository institutions were allowed to pay interest on business demand deposits, there would be a second budgetary effect that would reduce--but not eliminate--the net revenue loss from the payment of interest. In particular, based on a survey by the Board of Governors of the Federal Reserve System, we would expect reserve balances to increase because depository institutions would close a significant share of their retail and business sweep accounts and, as a result, maintain a higher level of required reserves. By doing so, the institutions could eliminate the costs of maintaining the sweep accounts and receive a return on their required reserves. However, closing the sweep accounts could reduce the earnings of banks because the return on required reserves--approximately the federal funds rate--likely would be lower than what they could receive with free use of the funds from the sweep accounts.

CBO assumes that, by 2002, depository institutions would eliminate 30 percent of both retail and business sweep accounts currently in existence, and half of those that otherwise would be established. Although FRREE would not permit the payment of interest on business demand deposits until January 1, 2001, the bill would allow businesses to deposit funds in a new money market account (MMDA) upon enactment of the bill through December 31, 2000. Depositors in those accounts would receive interest and be permitted up to 24 transactions in any month. Because reserve requirements would also apply to those accounts, they would be similar in many ways to interest-bearing demand deposits. Despite the similarities, during this transition period CBO assumes a slower rate of closing of business sweep accounts than if interest were immediately allowed on business demand deposits. As a result of the closings of retail and business sweep accounts, demand deposits on which required reserves are calculated would increase at depository institutions. CBO therefore projects that required reserve balances would increase above the level expected under current law, by about $10 billion in 2001 and $19 billion by 2004.

Although the Federal Reserve would pay interest on the added reserves at approximately the federal funds rate, it would invest the reserves in Treasury securities, earning a rate of return in excess of the federal funds rate by an amount estimated at 0.65 of a percentage point. As a result of the rate differential, the Federal Reserve would generate additional profits of about $450 million through 2004 and return them to the Treasury as governmental receipts. Other corporate profits, including those of the firms that generate the computerized sweep account software and the depository institutions, would decline on net, however, by the same amount as the increase in the Federal Reserve's profits. (Again, overall profits in the economy would be unchanged.) The reduced profits of corporations would cause corporate income tax receipts to fall, assuming the same marginal tax rate of 25 percent, by about $115 million through 2004. The overall net effect of the added reserves would be to increase governmental receipts by about $30 million in 2000 and $340 million over the 2000-2004 period. This effect, therefore, offsets about 35 percent of the five-year revenue loss estimated to occur if there were no change in projected reserves.

The overall estimated budgetary effect of the provisions allowing interest on reserve balances and interest on commercial demand deposit accounts is a reduction in revenues of $214 million in 2000 and $661 million over the 2000-2004 period. Over the period from 2005 through 2009, the overall revenue loss would total $571 million, making the 10-year revenue loss slightly more than $1.2 billion.

Special Reserve for SAIF

The bill would repeal the requirement for the Savings Association Insurance Fund to retain a special reserve fund. CBO expects that the cost of that repeal would total less than $500,000 in any year.

The Deposit Insurance Funds Act of 1996 required the Federal Deposit Insurance Corporation to set aside, on January 1, 1999, all balances in the SAIF in excess of the required reserve level of $1.25 per $100 of insured deposits. The reserve funds become available to pay for losses in failed institutions only if the SAIF’s reserve balance subsequently falls below 50 percent of the required reserve level, and the FDIC determines that it is expected to remain at that level for a year.

In January 1999, the FDIC allocated $1 billion of the SAIF’s balances to the special reserve. CBO's baseline assumes administrative costs and thrift failures will remain sufficiently low to avoid raising assessment rates on SAIF-insured institutions through 2004. We expect that the SAIF’s fund balances of about $10 billion will continue to earn interest, and that the fund’s ratio of reserves to insured deposits will climb each year, reaching over 1.4 percent by 2004.

Although CBO’s baseline estimates do not assume that the cost of thrift failures in any year would exceed the net interest earned by the SAIF, unanticipated thrift failures could result in a drop in the SAIF’s reserve ratio below 1.25 percent. The baseline reflects CBO's best judgment as to the expected value of possible losses during a given year, but annual losses will likely vary from the levels assumed in the CBO baseline. Thus, some small probability exists that thrift failures could increase sufficiently to drive the reserve ratio below the required level of 1.25 percent, but not so low as to trigger use of the special reserve.

When the balance of an insurance fund dips below the required ratio, the FDIC is forced to increase assessments for deposit insurance to restore the fund balance to the required level. Thus, if thrift losses were to exceed baseline estimates by a significant amount, we would expect the FDIC to increase insurance rates in order to maintain the SAIF's fund balance. Eliminating the special reserve would add to the fund balances and would make it less likely that the FDIC would have to raise insurance premiums. The probability that this change would affect premium rates is quite small, however, and therefore CBO expects that the cost of forgone deposit insurance premiums that could result from eliminating the special reserve would total less than $500,000 in any year.

PAY-AS-YOU-GO CONSIDERATIONS

The Balanced Budget and Emergency Deficit Control Act sets up pay-as-you-go procedures for legislation affecting direct spending or receipts. CBO estimates that FRREE would reduce receipts by $1,232 million over the period from 2000 through 2009, as shown in the following table. All of the effect on receipts is caused by the provisions authorizing the Federal Reserve to pay interest on required reserves and depository institutions to offer business demand deposit accounts. For the purposes of enforcing pay-as-you-go procedures, only the effects in the current year, the budget year, and the succeeding four years are counted.

	By Fiscal Year, in Millions of Dollars										
	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
Changes in outlays	0	0	0	0	0	0	0	0	0	0	0
Changes in receipts	0	-214	-161	-91	-95	-100	-104	-109	-114	-119	-125

The budget excludes from pay-as-you-go calculations expenses associated with maintaining the deposit insurance commitment. CBO believes that the costs related to eliminating the SAIF’s special reserves would not qualify for that exemption and thus would count for pay-as-you-go purposes. We estimate that the increase in cost resulting from the possibility that SAIF will lose future premium income would be less than $500,000 annually.

ESTIMATED IMPACT ON STATE, LOCAL, AND TRIBAL GOVERNMENTS

FRREE contains no intergovernmental mandates as defined in UMRA and would have no significant effects on the budgets of state, local, or tribal governments.

ESTIMATED IMPACT ON THE PRIVATE SECTOR

Many provisions in FRREE would change existing laws in ways that could lower the costs to depository institutions of complying with existing federal requirements. The bill would also authorize the Federal Reserve to pay interest on reserve balances held on deposit at the Federal Reserve. In addition, the bill would authorize the Board of Governors of the Federal Reserve System to prescribe regulations concerning the responsibilities of correspondent banks that maintain balances at the Federal Reserve on behalf of other institutions. (Commercial banks, Federal Home Loan Banks, and corporate credit unions, for example, serve as correspondent banks for many depository institutions that are not members of the Federal Reserve.)

Based on information provided by the Board of Governors of the Federal Reserve System, CBO expects the Federal Reserve would not use its authority to issue regulations unless problems arose in the crediting and distribution of interest earnings. Thus, this provision would not impose a private-sector mandate as defined by UMRA. If the Federal Reserve determined a rule was necessary, it would most likely require correspondent banks to pass the interest earnings back to the institutions for which they maintain required balances at the Federal Reserve. The cost to the correspondent banks of complying with such a rule would be negligible.

ESTIMATE PREPARED BY:

Federal Revenues: Carolyn Lynch
Federal Spending: Mary Maginniss
Impact on the Private Sector: Patrice Gordon

ESTIMATE APPROVED BY:

Tom Woodward
Assistant Director for Tax Analysis

Robert A. Sunshine
Deputy Assistant Director for Budget Analysis