CONGRESSIONAL BUDGET OFFICE
COST ESTIMATE

November 29, 2006

S. 2856
Financial Services Regulatory Relief Act of 2006

As cleared by the Congress on September 30, 2006,
and signed by the President on October 13, 2006

SUMMARY

S. 2856 (enacted as Public Law 109-351) affects the operations of financial institutions and the agencies that regulate them. Effective October 1, 2011, it allows the Federal Reserve System to pay interest on certain reserve balances of depository institutions that are held on deposit at the Federal Reserve, and gives the Board of Governors of the Federal Reserve greater flexibility in setting reserve requirements. Other provisions modify the regulatory standards for certain types of financial transactions, expand and clarify federal authorities and procedures for enforcing regulations, and give financial regulatory agencies more flexibility in sharing data, retaining records, and scheduling examinations. Finally, the act allows federal agencies to lease land to credit unions without charge.

CBO estimates that the law will have no effect on federal revenues through 2011 but will reduce revenues by a total of $1.4 billion over the 2012-2016 period. In addition, we estimate that direct spending will increase by $2 million over the 2007-2011 period and by a total of $6 million over the 2007-2016 period.

ESTIMATED COST TO THE FEDERAL GOVERNMENT

The estimated budgetary impact of this act is shown in Table 1. The costs of this legislation fall within budget function 370 (commerce and housing credit).

TABLE 1. ESTIMATED BUDGETARY EFFECTS OF THE FINANCIAL SERVICES REGULATORY RELIEF ACT OF 2006

	By Fiscal Year, in Millions of Dollars									
	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016
CHANGES IN REVENUES [a]										
Estimated Revenues	0	0	0	0	0	-253	-264	-278	-293	-308
CHANGES IN DIRECT SPENDING										
Estimated Budget Authority	*	*	*	1	1	1	1	1	1	1
Estimated Outlays	*	*	*	1	1	1	1	1	1	1

NOTE: * = less than $500,000.

a. Negative revenues indicate a reduction in revenue collections.

BASIS OF ESTIMATE

Most of the budgetary impact of this legislation will result from provisions allowing the Federal Reserve System to pay interest on certain reserve balances. Enacting this legislation also will affect the workload at agencies that regulate financial institutions. We estimate that the net change in agencies' spending will not be significant. Based on information from each of the agencies, CBO estimates that the change in administrative expenses—both costs and potential savings—will average less than $500,000 a year over the next several years. Expenditures of the Office of the Comptroller of the Currency, the Office of Thrift Supervision, the National Credit Union Administration (NCUA), and the Federal Deposit Insurance Corporation (FDIC) are classified as direct spending and will be covered by fees or insurance premiums paid by the institutions they regulate. Any change in spending by the Federal Reserve will affect federal revenues.

Revenues

The provisions of the legislation that significantly affect revenues are effective October 1, 2011. Starting then, the law will allow the Federal Reserve System to pay interest on any reserve balances held on deposit at the Federal Reserve by insured depository institutions and will provide greater flexibility to the Board of Governors in setting reserve requirements.

CBO estimates that the act will not affect revenues over the 2007-2011 period and will reduce revenues by $1.4 billion over the 2012-2016 period.

The delayed effective date of this legislation introduces more uncertainty regarding the policies that the Federal Reserve will adopt after October 1, 2011. It is possible that the Federal Reserve will take an entirely different set of actions than it would with an earlier effective date. The Board will have more time to study the ramifications of any policy changes, and changes may occur within the economy that will prompt the Board to adopt a different set of actions than if the policy were effective sooner. However, CBO has no basis for predicting such an outcome. Therefore, CBO assumes that the Federal Reserve will adopt policies after October 1, 2011, that are similar to the ones CBO would have assumed if the act had taken effect now.

CBO estimates that, after the effective date of the legislation, the Federal Reserve will pay interest on reserve balances held on deposit at the Federal Reserve. CBO anticipates that there will be sufficient knowledge within the business community of the possible policy changes that the Federal Reserve will make and the ramifications on their businesses to allow companies and individuals to implement their responses to any policy changes with very little lag after any policy changes in 2012. CBO anticipates that the initial budgetary effect of the legislation will be a decrease in the payment of profits from the Federal Reserve System to the U.S. Treasury. The Federal Reserve remits its profits to the Treasury, and those payments are classified as governmental receipts, or revenues, 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 constitute the bulk of its liabilities. Since the Federal Reserve currently pays no interest on reserves or currency, and the Treasury 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 legislation will decrease the Federal Reserve's profits and thereby reduce federal revenues. This budgetary response has three significant components. First, the Federal Reserve's payment of interest on required reserve balances held at Federal Reserve banks will tend to reduce governmental receipts. CBO anticipates that some depository institutions and depositors will respond to the interest payments on reserves by shifting funds out of consumer "retail" sweep accounts and into demand deposit accounts. This secondary response will increase required reserve balances, although the Federal Reserve could offset a portion of that increase by lowering reserve requirements. The net increase in reserves will partially offset the loss in federal revenues from the payment of interest on reserves. Finally, those net reductions in the Federal Reserve's earnings will act like reductions in indirect business taxes, generating increases in other incomes in the economy and subsequently higher income and payroll taxes. Those higher income and payroll taxes will offset the declines in the Treasury's receipts from the Federal Reserve by an estimated 25 percent, roughly the marginal tax rate on overall incomes in the economy.

Allowing the Federal Reserve to Pay Interest on Reserve Balances. Depository institutions hold three types of balances at the Federal Reserve—required reserve balances, contractual clearing balances, and excess reserve balances. Required reserve balances are the balances that a depository institution must hold to meet reserve requirements. Depository institutions may also hold additional balances, called required or contractual clearing balances, which can earn an implicit rate of interest in the form of an interest credit that is used to defray fees for Federal Reserve services. Contractual clearing balances have risen over the past decade from under $2 billion in 1990 to between $8 billion and $10 billion today. Excess reserves are funds held in addition to a depository institution's required reserve and contractual clearing balances.

Interest on Required Reserve Balances. The budgetary effect of paying interest on required reserve balances consists of three components. First, the act will result in the Federal Reserve paying interest on the required reserve balances expected under current law, thus reducing its net income and, therefore, governmental receipts. Second, the payment of interest on reserves will cause demand deposit balances at depository institutions to increase. That increase will raise the amount of reserve balances held at the Federal Reserve. The higher reserve balances at the Federal Reserve will increase its earnings because it will invest the balances at a higher rate than it will pay on them. This change in projected reserves will increase governmental receipts but will only partially offset the loss caused by the payment of interest on reserves projected under current law. Third, the net reduction in the Federal Reserve's earnings from the first two effects will be partially offset by increased income and payroll tax receipts.

Interest Payments on Required Reserves Projected Under Prior Law. Because depository institutions did not previously earn a return on required reserve balances, they had an incentive to minimize such balances. Required reserve balances measured almost $30 billion at the end of 1993 but generally have ranged between $7.5 billion and $12 billion in the past year. The expansion of retail and business sweep accounts has caused this general decline. In typical sweep accounts, banks shift their depositors' funds from demand deposits, against which reserves are required, into other depository accounts, against which reserves are not 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. They originated and grew in importance because financial institutions cannot pay interest on business demand deposits. Advances in computer technology in the 1990s made the shifting of funds feasible for many consumer accounts as well. CBO expects the expansion of retail and business sweep accounts to continue, in part because of the effects of rising interest rates.

Under this law, after October 1, 2011, the Federal Reserve can choose the interest rate it pays on reserve balances, although the rate chosen cannot exceed the general level of short-term interest rates. When the legislation was drafted with an effective date in the near future, staff at the Federal Reserve indicated that the Federal Reserve would choose an interest rate near the key short-term rate, the federal funds rate. CBO assumes that the Federal Reserve will adopt a similar policy in 2012, paying interest only on required reserves at a rate 10 to 15 basis points below the federal funds rate.

CBO projects that the federal funds rate will average about 4.5 percent over the nine-year period from 2008 through 2016. The payment of interest on reserves is assumed to start early in fiscal year 2012. CBO projects that the legislation will cause the Federal Reserve to pay interest to depository institutions of $359 million in 2012 on about $8.3 billion of required reserve balances expected under current law. Thereafter, the interest paid to depository institutions will be higher because required reserves will grow based on growth of the economy. Such interest payments are estimated to total about $2 billion over the 2012-2016 period. Those payments will reduce the profits of the Federal Reserve—and thus its payments to the Treasury—by the same amount (see Table 2).

Projected Impact of the Law on the Volume of Reserves. If the Federal Reserve pays interest on required reserve balances, there will be a second budgetary effect on the Federal Reserve that will reduce, but not eliminate, the net revenue loss from the payment of interest. In particular, CBO expects that reserve balances will increase because some depository institutions will close some of their retail sweep accounts and, as a result, maintain a higher level of required reserves.

Based on information provided by the Board of Governors of the Federal Reserve, CBO projects that many banks will see little reason to unwind their existing retail sweep programs. CBO estimates that depository institutions will eliminate approximately 5 percent of retail sweep accounts beginning in 2012. As a result, the amount of demand deposits for which reserves are required will increase. (The payment of interest on reserves will have no effect on business sweep accounts because it will offer no incentive to businesses to discontinue their current practices regarding sweep activity. The act does not lift the ban on interest payments on business demand deposits.)

TABLE 2. ESTIMATED BUDGETARY IMPACT OF PAYING INTEREST ON RESERVE BALANCES

	By Fiscal Year, In Millions of Dollars									
	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016
CHANGES IN REVENUES										
Revenues from Federal Reserve:										
Interest on Required Reserves	0	0	0	0	0	-359	-375	-395	-416	-437
Profits from Increased Reserves	0	0	0	0	0	22	22	24	25	26
Net Effect on Revenue from Federal Reserve	0	0	0	0	0	-337	-352	-371	-391	-411
Income and Payroll Tax Offsets	0	0	0	0	0	84	88	93	98	103
Net Effect of Allowing Interest on Reserves	0	0	0	0	0	-253	-264	-278	-293	-308

NOTE: Numbers may not add up to totals because of rounding.

CBO does not expect the increase in reserves from the closing of many sweep accounts to be significant enough to affect the level of reserves needed for implementing monetary policy. The legislation will relax the current lower bound on reserve requirements, thereby providing the Federal Reserve with the option of lowering reserve requirements, perhaps substantially. The Federal Reserve has indicated that it will study possible strategies for setting reserve requirements in such an environment.

Currently, the Federal Reserve can set reserve requirements as high as 14 percent and as low as 8 percent of transactions deposits (above a fixed threshold). The Federal Reserve has kept the requirement at 10 percent for most transactions deposits since 1992. The law removes the lower limit of 8 percent. However, CBO assumes that required reserves will be maintained at roughly $10 billion to $15 billion, which is consistent with balances in the past five years and would not require any change in reserve requirements, under CBO's assumptions.

CBO projects that, after the Federal Reserve changes its policies in 2012, the required reserve balances will be greater than under the current policy structure and the balances will generate additional net income to the Federal Reserve. Although the Federal Reserve will pay interest on the added reserves at approximately the federal funds rate, it will invest the reserves in Treasury securities, earning a rate of return approximately 0.6 of a percentage point more than it pays. As a result of that differential, CBO estimates that the Federal Reserve will generate profits on the added revenues of about $119 million over the 2012-2016 period.

Projected Offsetting Impact on Tax Revenues. Allowing interest on required reserve balances held at the Federal Reserve will have a third budgetary effect, which will also partially offset the decline in revenue from the payment of interest on current balances. The current reserve requirement on depository institutions, without provision of interest, is like an indirect business tax. Allowing interest payments on reserves, therefore, will generate the same economic effects as does removing an excise tax. Assuming that GDP remains unchanged, reductions in excise tax receipts generate equal increases in other incomes in the economy. The higher incomes produce increases in income and payroll taxes that offset an estimated 25 percent of the reduction in excise tax receipts, roughly the marginal tax rate on overall incomes in the economy. In this case, a quarter of the loss in receipts to the Treasury from the Federal Reserve will be offset by an increase in income and payroll tax receipts. CBO estimates that the loss in receipts from the Federal Reserve will total $1.9 billion from 2012 through 2016, offset partially by an increase in income and payroll taxes of $466 million.

Impact on Other Balances Held at the Federal Reserve. The estimate assumes no change in the current arrangements regarding *contractual clearing* balances. However, a great deal of uncertainty exists regarding how the Federal Reserve will structure its policy regarding contractual clearing balances after October 1, 2011. A change in that policy could affect federal revenues, but the staff at the Federal Reserve have provided no indication of whether a change will occur or what any change will entail except to indicate that one policy will be prescribed for all depository institutions regarding contractual clearing balances. CBO believes that the Federal Reserve will choose not to pay interest on *excess* reserve balances, unless required reserve balances fall to such a low level that interest on excess reserves would be needed to build reserves. That is an unlikely scenario.

Direct Spending

CBO estimates that this legislation will increase direct spending by $2 million over the 2007-2011 period and $6 million over the 2007-2016 period by reducing offsetting receipts collected from credit unions that lease federal facilities. The act also could affect the cost of deposit insurance, but CBO has no basis for estimating the amount of the net change in spending that will result.

Section 501 authorizes federal agencies to lease land to federal credit unions without charge under certain conditions. Under previous law, agencies could allocate space in federal buildings without charge if at least 95 percent of the credit union's members are or were federal employees. Some credit unions, primarily those serving military bases, have leased federal land to build a facility. Prior to 1991, leases awarded by the Department of Defense (DoD) were free of charge and for terms of up to 25 years; a statutory change enacted that year limited the term of such leases to five years and required the lessee to pay a fair market value for the property. According to DoD, about 35 credit unions have leased land since 1991 and are paying a total of about $525,000 a year to lease federal property. Those proceeds are recorded as offsetting receipts, and any spending of those payments is subject to appropriation.

Implementing section 501 will result in a loss of offsetting receipts from all credit union leases. Those lessees currently paying a fee will stop making those payments after they renew their current leases, all of which should expire within the next five years. In addition, credit unions that have long-term, no-cost leases will be able to renew them without becoming subject to the fees they otherwise would have paid. CBO estimates that this provision will cost a total of about $2 million over the next five years and an average of about $700,000 annually after 2011.

PREVIOUS CBO ESTIMATE

CBO has prepared several cost estimates for legislation that contained provisions similar to those in this act. They include: S. 2856, as ordered reported by the Senate Committee on Banking, Housing, and Urban Affairs on May 5, 2006 (CBO's estimate was transmitted on May 18, 2006); H.R. 3505, the Financial Services Regulatory Relief Act of 2005, as ordered reported by the House Committee on the Judiciary on February 15, 2006 (estimate transmitted on February 16, 2006); H.R. 3505, as ordered reported by the House Committee on Financial Services on November 16, 2005 (estimate transmitted on December 8, 2005); H.R. 3508, the 2005 District of Columbia Omnibus Authorization Act, as ordered reported by the House Committee on Government Reform on September 15, 2005 (estimate transmitted on October 12, 2005); and H.R. 1224, the Business Checking Freedom Act of 2005, as ordered reported by the House Committee on Financial Services on April 27, 2005 (estimate transmitted on May 10, 2005).

The provisions of this act that affect direct spending are identical to those in S. 2856 and H.R. 3505, and the estimated costs are the same as those shown in CBO's May 18, 2006 estimate. Differences between the estimated revenue impact of the act and the estimated revenue impacts of S. 2856, H.R. 3505, and H.R. 1224 are due to the different effective date of the provision allowing the Federal Reserve to pay interest on reserves and a lower estimate of the likelihood that depositary institutions will discontinue consumer "retail" sweep accounts when the Federal Reserve begins to pay interest on required reserves.

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