CONGRESSIONAL BUDGET OFFICE
COST ESTIMATE

May 18, 2006

Financial Services Regulatory Relief Act of 2006

As ordered reported by the Senate Committee on Banking, Housing, and Urban Affairs on May 4, 2006

SUMMARY

This bill would affect the operations of financial institutions and the agencies that regulate them. It would allow the Federal Reserve System to pay interest on certain reserve balances of depository institutions that are held on deposit at the Federal Reserve, and would give the Board of Governors of the Federal Reserve greater flexibility in setting reserve requirements. Other provisions would 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 bill would allow federal agencies to lease land to credit unions without charge and direct the Government Accountability Office (GAO) to conduct various studies.

CBO estimates that enacting this bill would reduce federal revenues by $1.0 billion over the 2007-2011 period and by a total of $2.4 billion over the 2007-2016 period. In addition, we estimate that direct spending would increase by $2 million over the 2007-2011 period and by a total of $6 million over the 2007-2016 period. Provisions affecting programs funded by annual appropriations would cost another $1 million in 2007, CBO estimates.

The legislation contains intergovernmental mandates as defined in the Unfunded Mandates Reform Act (UMRA), but CBO estimates that the cost of complying with the requirements would be small and would not exceed the threshold established in UMRA ($64 million in 2006, adjusted annually for inflation).

The bill contains several private-sector mandates as defined in UMRA. Those mandates would affect certain depository institutions, nondepository institutions that control depository institutions, uninsured banks, certain holding companies, and parties with contracts or agreements with depository institutions that go into conservatorship or receivership. At the same time, the bill would relax some restrictions on the operations of certain financial institutions. CBO estimates that the aggregate direct costs of complying with the private-

sector mandates in the bill would not exceed the annual threshold established by UMRA ($126 million in 2006, adjusted annually for inflation).

ESTIMATED COST TO THE FEDERAL GOVERNMENT

The estimated budgetary impact of this bill 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										
	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016
CHANGES IN REVENUES [a]											
Estimated Revenues	0	-192	-192	-202	-212	-221	-242	-253	-266	-293	-308
CHANGES IN DIRECT SPENDING											
Estimated Budget Authority	0	*	*	*	1	1	1	1	1	1	1
Estimated Outlays	0	*	*	*	1	1	1	1	1	1	1
CHANGES IN SUBJECT TO APPROPRIATION											
Estimated Authorization Level	0	1	0	0	0	0	0	0	0	0	0
Estimated Outlays	0	1	0	0	0	0	0	0	0	0	0

NOTE: * = Revenue loss or spending of less than $500,000.

a. Negative revenues indicate a reduction in revenue collections.

BASIS OF ESTIMATE

For this estimate, CBO assumes that the legislation will be enacted near the end of fiscal year 2006.

Most of the budgetary impact of this legislation would result from provisions allowing the Federal Reserve System to pay interest on certain reserve balances. Enacting this bill also would affect the workload at agencies that regulate financial institutions. We estimate that the net change in agencies' spending would not be significant. Based on information from each of the agencies, CBO estimates that the change in administrative expenses—both costs and potential savings—would 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 would be covered by fees or insurance premiums paid by the institutions they regulate. Any change in spending by the Federal Reserve would affect net revenues, while adjustments in the budgets of the Securities and Exchange Commission (SEC) and Government Accountability Office would be subject to appropriation.

Revenues

The legislation would allow the Federal Reserve System to pay interest on any reserve balances held on deposit at the Federal Reserve by insured depository institutions. The Board of Governors of the Federal Reserve Board would have greater flexibility in setting reserve requirements. CBO estimates that the bill would reduce revenues by $1.0 billion over the 2007-2011 period and by $2.4 billion over the 2007-2016 period.

The initial budgetary effect of the bill would 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 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 bill would 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 would tend to reduce governmental receipts. CBO anticipates that some depository institutions and depositors would respond to the interest payments on reserves by shifting funds out of consumer "retail" sweep accounts and into demand deposit accounts. This secondary response would increase required reserve balances although the Federal Reserve would be expected to offset a portion of that increase by lowering reserve requirements. The net increase in reserves would partially offset the loss in federal revenues from the payment of interest on reserves. Finally, those net reductions in Federal Reserve receipts would 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 would offset the declines in Federal Reserve receipts 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 $6.5 billion and $7.0 billion today. Excess reserves are funds held at reserve banks in excess of a depository institution's required reserve and contractual clearing balances.

Interest on Required Reserve Balances. The budgetary effect of interest on required reserve balances consists of three components. First, the bill would 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 would cause demand deposit balances at depository institutions to increase. That increase would raise the amount of reserve balances held at the Federal Reserve, although the increase would likely be diminished by actions taken by the Federal Reserve to reduce reserve requirements. The higher reserve balances at the Federal Reserve would increase its earnings because it would invest the balances at a higher rate than it would pay on them. This change in projected reserves would increase governmental receipts, but would 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 receipts from the first two effects would be partially offset by increased income and payroll tax receipts.

Interest Payments on Required Reserves Projected Under Current Law. Because depository institutions currently do not earn a return on required reserve balances, they have 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. Under current law, CBO expects the expansion of retail and business sweep accounts to continue, in part because of the effects of rising interest rates. CBO expects required reserve balances to decline to about $6.5 billion over the next two years and to rise gradually in subsequent years, with growth in the economy.

Under this bill, the Federal Reserve would be allowed to choose the interest rate it pays on reserve balances, although the rate chosen could not exceed the general level of short-term interest rates. Staff at the Federal Reserve have indicated that the Federal Reserve would choose an interest rate near the key short-term rate, the federal funds rate. The likely rate would be 10 to 15 basis points lower than the federal funds rate to account for the lack of risk. Accordingly, CBO assumes that the Federal Reserve would pay interest only on required reserves at a rate of 10 to 15 basis points below the federal funds rate.

CBO projects that the federal funds rate will average about 4.75 percent in 2007 and 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 2007. CBO projects that the legislation would cause the Federal Reserve to pay interest to depository institutions of about $300 million in 2007 on about $6.5 billion of required reserve balances expected under current law. Throughout the projection period, the interest paid to depository institutions would be higher because required reserves under current law will grow based on growth of the economy. Such interest payments would total about $1.6 billion over the 2007-2011 period and $3.6 billion over the 2007-2016 period. Those payments would 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 Bill on the Volume of Reserves. If the Federal Reserve pays interest on required reserve balances, there would be a second budgetary effect on the Federal Reserve that would reduce, but not eliminate, the net revenue loss from the payment of interest. In particular, CBO expects that reserve balances would increase because depository institutions would close a significant share of their retail sweep accounts and, as a result, maintain a higher level of required reserves. Under current law, depository institutions are already allowed to pay interest on consumer demand deposits. By closing a significant share of the retail sweep accounts, depository institutions could eliminate the costs of maintaining the sweep accounts and receive a return on their required reserves, although presumably at a lower rate than what they could receive if they invested the funds in other ways. The payment of interest on reserves would have no effect on business sweep accounts because it would offer no incentive to businesses to discontinue their current practices regarding sweep activity. (The bill would 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)										
	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016
CHANGES IN REVENUES											
Revenues from Federal Reserve:											
Interest on Required Reserves	0	-299	-298	-313	-328	-343	-359	-375	-395	-416	-437
Profits from Increased Reserves	0	43	42	44	46	48	36	38	40	25	27
Net Effect on Revenue from Federal Reserve	0	-256	-256	-269	-282	-295	-323	-337	-355	-390	-410
Income and Payroll Tax Offsets	0	64	64	67	71	74	81	84	89	98	103
Net Effect of Allowing Interest on Reserves	0	-192	-192	-202	-212	-221	-242	-253	-266	-293	-308

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

CBO estimates that depository institutions would eliminate approximately 30 percent of retail sweep accounts currently in existence by 2009 and half of those that otherwise would be established. As a result, demand deposits for which reserves are required would increase at depository institutions.

The increase in reserves from the closing of many sweep accounts would likely provide the Federal Reserve with more reserves than needed for implementing monetary policy. The legislation would relax the current lower bound on reserve requirements, therefore providing the Federal Reserve with the option of lowering reserve requirements, perhaps substantially, in the face of increasing reserves. The Federal Reserve has indicated that it would study possible strategies for setting reserve requirements in such an environment.

Under current law, 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 legislation would remove the lower limit of 8 percent.

CBO assumes the Federal Reserve would offset a part of the increase in reserve balances by lowering reserve requirements. The magnitude and timing of such changes is very uncertain, but CBO assumes that required reserves would be maintained at roughly $10 billion to $15 billion, which is consistent with balances in the past five years.

As a result, CBO projects that required reserve balances would be greater than under current law and thus generate additional net income to the Federal Reserve. 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 approximately 0.6 of a percentage point more than it pays. As a result of that differential, the Federal Reserve would generate additional profits of about $223 million over the 2007-2011 period and $389 million over the 2007-2016 period.

Projected Offsetting Impact on Tax Revenues. Allowing interest on required reserve balances held at the Federal Reserve would have a third budgetary effect, which would 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, would 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 would be offset by an increase in income and payroll tax receipts. CBO estimates that the loss in Federal Reserve receipts would total $1.4 billion from 2007 through 2011, offset partially by an increase in income and payroll taxes of $340 million. Over the 2007-2016 period, the loss in Federal Reserve receipts would total about $3.2 billion, and the increase in income and payroll taxes would total about $0.8 billion.

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 would structure its policy regarding contractual clearing balances if this legislation was enacted. A change in that policy could affect federal revenues, but the staff at the Federal Reserve have provided no clear indication of whether a change would occur or what any change would entail except to indicate that one policy would be prescribed for all depository institutions regarding contractual clearing balances. CBO believes that the Federal Reserve would 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 enacting this legislation would 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. Enacting the bill also could affect the cost of deposit insurance, but CBO has no basis for estimating the amount of the net change in spending that would result.

Credit Union Leases. Section 501 would allow federal agencies to lease land to federal credit unions without charge under certain conditions. Under existing law, agencies may 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.

CBO expects that enacting this provision would result in a loss of offsetting receipts from all credit union leases. Those lessees currently paying a fee would 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 would be able to renew them without becoming subject to the fees they otherwise would pay under current law. CBO estimates that enacting this provision would cost a total of about $2 million over the next five years and an average of about $700,000 annually after 2011.

Deposit Insurance. Several provisions in the bill could affect the cost of federal deposit insurance. For example, the bill would enhance the ability of the FDIC and NCUA to negotiate with other parties regarding the disposition of certain assets of failed institutions. Such changes could reduce the government's losses from future failures in some circumstances. It is also possible, however, that some of the new business arrangements authorized by the bill could increase the risk of losses to the deposit insurance funds. The net budgetary impact of such changes would likely be negligible over time because any significant increase or decrease in costs would be offset by adjustments in the insurance premiums paid by banks, thrifts, or credit unions.

Spending Subject to Appropriation

The legislation also would affect spending for activities funded by annual appropriations. It would direct the GAO to prepare two studies, one related to currency transaction reports filed with Department of the Treasury, and one on issues related to the effectiveness and efficiency of the current approach to regulating financial institutions. Based on information from GAO, CBO estimates that completing those studies would cost about $1 million in 2007.

The bill also would require the SEC to issue new regulations on various matters, exempt thrift institutions from certain registration requirements, and exempt certified public accountants from certain disclosure requirements. Based on information from the SEC, CBO estimates that the budgetary effects of those changes would not be significant.

ESTIMATED IMPACT ON STATE, LOCAL, AND TRIBAL GOVERNMENTS

The legislation contains intergovernmental mandates, as defined in UMRA, because it would limit certain fees that bank supervisors may impose on banks not domiciled in their state and place certain notification requirements on bank supervisors. The bill also would preempt state laws if banks or credit unions go into receivership. Based on information from industry authorities and state entities, CBO estimates that these provisions would impose minimal costs, if any, on state, local, and tribal governments that would not exceed the threshold established in UMRA ($64 million in 2006, adjusted annually for inflation).

Other provisions of the bill would impose no costs on state, local, or tribal governments.

ESTIMATED IMPACT ON THE PRIVATE SECTOR

The bill contains several private-sector mandates as defined in UMRA. The mandates in the bill would impose:

- Requirements on certain insured depository institutions and parties affiliated with such institutions with respect to safety and soundness;

- Restrictions on parties with certain contracts or agreements with depository institutions that go into conservatorship or receivership; and

- Restrictions on participation in the affairs of certain financial institutions by people convicted of certain crimes.

At the same time, the bill would relax some restrictions on the operations of certain financial institutions. CBO estimates that the aggregate direct costs of mandates in the bill would not exceed the annual threshold established in UMRA ($126 million in 2006, adjusted annually for inflation).

Enhanced Safety and Soundness Enforcement

The bill would expand and enhance some of the authorities of federal banking agencies with respect to troubled or failing institutions, and certain parties affiliated with those institutions. For example, the bill would enhance the authority of banking agencies to enforce certain conditions imposed on depository institutions and parties affiliated with such institutions. The bill also would make companies that control depository institutions subject to certain authorities of the FDIC. Based on information from the FDIC, CBO expects that the cost to the private sector of these expanded authorities would be small.

The Gramm-Leach-Bliley Act allowed new forms of affiliations among depositories and other financial services firms. Consequently, insured depository institutions may now be controlled by a company other than a depository institution holding company (DIHC). The bill would amend current law to give the FDIC certain authorities concerning troubled or failing depository institutions held by those new forms of holding companies.

Cross-Guarantee Authority. Under current law, if the FDIC suffers a loss from liquidating or selling a failed depository institution, the FDIC has the authority to obtain reimbursement from any insured depository institution within the same DIHC. Section 703 would expand the scope of the FDIC's reimbursement power to include all insured depository institutions controlled by the same company, not just those controlled by the same DIHC.

The cost of this mandate would depend, among other things, on the probability of failure of the additional institutions subject to this authority and the probability that the FDIC would incur a loss as a result of those failures. The new authority would apply only to a few depository institutions. Based on information from the FDIC, CBO estimates that the cost of this mandate would not be substantial.

Golden Parachute Authority and Nonbank Holding Companies. Section 704 would allow the FDIC to prohibit or limit any company that controls an insured depository from making "golden parachute" payments or indemnification payments to parties affiliated with troubled or failing insured depositories. (Affiliated parties include directors, officers, employees, and controlling shareholders. Such parties also include independent contractors such as accountants or lawyers who participate in violations of the law or undertake unsound business practices that may cause a financial loss to, or adverse effect on, the insured depository institution.)

Based on information from the FDIC, CBO expects that only a few institutions would be covered by the new authority. In the event that the FDIC exercises this authority, CBO expects that the cost to institutions of withholding such payments would be administrative in nature and minimal, if any.

Receiver or Conservator Consent Requirement

The bill would enhance the ability of the FDIC and NCUA to negotiate with parties to certain contracts or agreements with depository institutions that go into conservatorship or receivership. With some exceptions, the bill would require the consent of the receiver or conservator before any party to a contract with the insured depository institution would be allowed to exercise any right or power to terminate, accelerate, or declare a default under that contract during the 45-day period beginning on the date of conservatorship, or during the 90-day period beginning on the date of appointment of the receiver. The mandate would be on entities that have certain types of contracts with depository institutions that go into conservatorship or receivership. Based on information from the FDIC, CBO expects that the cost to the private sector of this provision over the next five years is likely to be minimal.

Restrictions on Convicted Individuals

Current law prohibits a person convicted of a crime involving dishonesty, a breach of trust, or money laundering from participating in the affairs of an insured depository institution without FDIC approval. The bill would extend that prohibition so that uninsured banks, bank holding companies, and savings and loan holding companies and their subsidiaries could not allow such persons to participate in their affairs without the prior written consent of their designated federal banking regulator.

Assuming that those institutions already screen potential directors, officers, and employees for criminal offenses, the incremental cost of complying with this mandate would be small.

PREVIOUS CBO ESTIMATE

CBO has transmitted several cost estimates for legislation that contained provisions similar to those in this bill. They include: H.R. 3505, as ordered reported by the House Committee on Financial Services on November 16, 2005 (transmitted on December 8, 2005); H.R. 3505, as ordered reported by the House Committee on the Judiciary on February 15, 2006 (transmitted on February 16, 2006); H.R. 1224, the Business Checking Freedom Act of 2005, as ordered reported by the House Committee on Financial Services on April 27, 2005 (transmitted on May 10, 2005); and 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 (transmitted on October 12, 2005).

The provisions of this bill that affect direct spending are identical to those in H.R. 3505, and the estimated costs are the same as those shown in CBO's February 15, 2006, estimate. Differences between the estimated revenue impact of this bill and the estimated revenue impacts of H.R. 3505 and H.R. 1224 are due to differences in the legislation and changes in CBO's economic assumptions.

H.R. 3505, as ordered reported by both the House Committee on Judiciary and the House Committee on Financial Services, would preempt certain state securities laws that require agents who represent a federal savings association to register as brokers or dealers if they sell certain products; it would also preempt state laws that regulate certain fiduciary activities performed by insured banks and other depository institutions. This bill does not contain such provisions, and the mandates statements reflect those differences.

H.R. 3505 had a mandate on certain industrial loan companies or industrial banks that is not included in this bill. This bill contains a mandate on parties with certain contracts with depository institutions that go into conservatorship or receivership that was not in H.R. 3505. The other mandates in this bill are similar to those in H.R. 3505. The aggregate cost of complying with the mandates in both bills would fall below UMRA's annual threshold for private-sector mandates.

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