FRBSF Weekly Letter

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Interest on Business Checking Accounts?

On March 31, 1986, regulators lifted interest rate ceilings on all personal deposit accounts except "demand" deposit accounts. Payment of interest on the latter, which are checking accounts with deposits legally available "on demand", continues to be prohibited by federal law. From an individual's point of view, this prohibition is immaterial because of the absence of ceilings on another type of checking account — the NOW (Negotiable Order of Withdrawal) account — which, for all practical purposes, is a perfect substitute for a demand deposit account. In effect, then, banks now do not face any restrictions on the interest they may pay on personal checking accounts.

One important interest rate ceiling, however, remains — a flat prohibition against the payment of interest on business checking accounts (i.e., demand deposits). Businesses currently are not permitted to have NOW accounts, so they cannot avoid the interest ceiling on demand deposits by switching to NOWs the way consumers can.

Recently, two regulatory proposals have reignited the controversy over whether depository institutions should be allowed to pay interest on business checking accounts. The Federal Deposit Insurance Corporation (FDIC) proposed to give state-chartered banks that are not members of the Federal Reserve System the authority to offer NOW accounts to their business customers. In addition, the Federal Home Loan Bank Board (which regulates thrifts) proposed to lift transaction restrictions on thrifts' money market deposit accounts (which are currently available to businesses). This would have the effect of removing interest ceilings on business checking accounts held at thrifts. Although neither proposal appears likely to go forward, this may be an opportune time to reconsider the merit of prohibiting the payment of interest on business checking accounts.

Some analysts argue that paying interest on business checking accounts simply would raise the costs of funds for banks (and thrifts) and depress their profits. Others argue that the removal of interest rate ceilings on business checking accounts would enhance the efficiency of the payments system, and might actually benefit banks and thrifts as a whole by shifting funds used for transaction purposes now held outside the depository industry into banks and thrifts. In this *Letter*, I discuss the merits of these arguments.

Effects of ceilings

The conventional wisdom (as reported in the popular press) seems to be that deposit rate ceilings somehow eliminate competition for deposits and thereby reduce the cost of attracting deposits. Some go as far as to argue that banks get their business demand deposits for free.

Proponents of this view apparently have neglected the fact that banks have to compete for deposits among one another and with nonbank, short-term liquid investment alternatives that are free of interest ceilings (such as Treasury securities and money market mutual funds). Thus, for a given bank to attract and hold deposits, it must at least partially match the returns available elsewhere.

Banks match the returns available elsewhere through various forms of "nonprice" (i.e., noninterest) competition. One common form of nonprice competition is the "compensating balance" arrangement. Under such an arrangement, banks offer various services below cost as compensation to businesses for holding their checking balances at banks. Thus, business checking deposits hardly constitute a free source of funds for banks.

Cash management in an unregulated world

In an interesting series of articles, economists Fisher Black (1970, 1975) and Eugene Fama (1980, 1983) have discussed what banking would be like in a completely unregulated world free of interest ceilings, reserve requirements and portfolio restrictions. They argue that, in principle, virtually all assets would be "checkable" directly, with the only limitation being the transaction costs involved in exchanging assets.

Although technology and financial markets may not have progressed to the point where it would be economically sensible for all assets to be checkable, the innovation of money market funds, which enable investors to write checks against various types of bonds, and "cash management" accounts at brokerage firms are but short steps from the world envisioned by these economists.

In such a completely unregulated world, banks would act more like today's money funds or brokerage houses. They would offer various types of business checking accounts that pay market-determined interest rates depending on the type of underlying asset and whether the bank or the depositor assumed the risk of changes in asset values; and banks would charge the marginal costs of actual transactions and asset exchanges. In such a world, there would be little incentive for cash management as we now know it (although there still would be portfolio management) since checking account deposits would be similar to other short-term liquid investments in terms of their yield.

Our world, of course, is not free from regulation, and considerable resources and an entire industry appear to be devoted to circumventing regulatory restrictions on business checking accounts. For example, many firms use overnight repurchase agreements (repos) as a cash management tool to earn, in effect, a market rate of interest on funds being held for transaction purposes. By holding only the funds needed for one day's *net* transactions in their checking accounts, huge volumes of transactions can be accomplished with very low average account balances. Similar arrangements are also used by the checkable money funds: participants in those funds hold checking accounts into which funds are transferred only as checks are presented for payment. Thus, money fund holders also can write very large volumes of checks on transaction balances that average close to zero.

Cash management activities in general are largely aimed at minimizing the level of balances in business checking accounts. One primary reason for cash management is the prohibition of interest payments on transaction accounts. If banks were free to pay market rates of interest on checking accounts, there would be little incentive to "sweep" these accounts daily into repos, Treasury securities or other higher yielding liquid investments. Instead, banks could hold the Treasury securities themselves, and thus allow depositors to avoid the daily transactions costs in trading them.

However, even if the interest ceiling were eliminated, reserve requirements would still limit the interest banks could pay to a level somewhat below market rates (currently about 88 percent of the market rate). Thus, to eliminate incentives for business cash management completely, either reserve requirements would have to be eliminated or interest paid on reserves. Doing either would, in turn, raise monetary control issues. Nevertheless, eliminating the ceiling alone might go a long way toward eliminating the incentive for many cash management activities.

Cash management activities to minimize balances in checking accounts are productive from the private beneficiary's point of view, but they are pure waste from society's viewpoint to the extent that they exist solely to circumvent regulations. (This is not to say that firms would not still have to manage their portfolios' liquidity and maturity in the absence of regulations.) Ironically, the ceilings on business checking accounts probably have been far more distortionary (in terms of attracting significant amounts of resources to circumvent them) than ceilings on individual accounts. This is because the much larger sums involved in a typical business account make it more worthwhile for businesses to try to evade interest ceilings.

Extent of cash management

The extent of these socially wasteful cash management practices may be very large as indicated by the amount of trading in government securities (Treasury bills, notes and bonds) — one of the liquid investments that substitute for business checking accounts. For the 36 primary government securities dealers alone, the *daily* volume of transactions is approximately $70 billion — large enough that the entire stock of federal debt turns over every month. Although a large number of these transactions are undoubtedly for normal investment purposes, the turnover rate of the government securities market is 25 times greater than that of the stock

market, suggesting that a large part of the government securities trading is for cash management purposes.

Even more astounding are the demand deposit turnover rates at major New York City banks (where many major corporations hold checking accounts). In 1984, the annual turnover rate at those banks was 1,843 — or about 7 times per business day. Although part of the high turnover is probably due to normal financial and business transactions, the very high level of turnover suggests that businesses are successful in keeping average balances extremely low relative to the amount of transactions. The annual turnover rate for all demand deposits (including consumer accounts) was an almost equally astonishing 434 — or almost twice a business day. The turnover rates of zero-interest checking accounts contrast sharply with those of consumer NOW accounts. The latter has an annual turnover rate of approximately 16 — about thirty times lower than the rate on all zero-interest demand deposits.

While a relatively large volume of business transactions undoubtedly are undertaken for the normal exchange of goods, services and financial assets, extremely large volumes and rapid turnover suggest that a large part of the observed transactions are for cash management purposes — to circumvent the interest ceilings and reserve requirements on demand deposits. Although each transaction may not be very costly in absolute terms, the total cost of these needless transactions might be high because the total annual volume of transactions for cash management purposes could easily be many times the gross national product.

Removing the ceilings

If the prohibition against paying interest on demand deposits were removed, there might be a large reduction in the amount of wasteful cash management. There is, however, a debate about whether the large number of transactions in the government securities market, the existence of the overnight repo market, the very large volume of wire transfers, and the extremely high turnover of demand deposits are due primarily to the restriction on interest payments or to reserve requirements.

Some argue that compensating balance arrangements enable banks to circumvent the interest ceiling almost perfectly and costlessly. Others argue that inefficiencies are involved in nonprice competition because at least some depositors value the services they receive at less than their cost.

Even if this latter argument were wrong and the interest ceiling on business checking accounts were being largely circumvented, eliminating the interest ceiling would simply result in some substitution of explicit interest for the implicit interest currently paid through compensating balance arrangements. And this would have no important effects on banks or the economy.

If compensating balance arrangements were not perfect substitutes for explicit interest payments, the removal of the ceilings would result in a reduction of wasteful cash management activities and indirect methods of compensation. Although the interest costs on demand deposits would rise, banks' total net costs (associated with demand deposits) would be largely unaffected in the long-run as underpriced services were eliminated. Moreover, banks likely would increase explicit fees for transactions. This too would lead to a reduction in socially wasteful transactions.

Increased fee income and reduced expenditures on providing non-priced services would, at least in the long-run, offset the increase in the explicit interest costs of demand deposits. Moreover, the degree of financial intermediation services provided by banks would increase. Although traders in government securities (which includes some large banks) and managers and owners of some of the money funds might suffer losses, the economy as a whole would benefit.

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Opinions expressed in this newsletter do not necessarily reflect the views of the management of the Federal Reserve Bank of San Francisco, or of the Board of Governors of the Federal Reserve System.

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BANKING DATA—TWELFTH FEDERAL RESERVE DISTRICT

(Dollar amounts in millions)

Selected Assets and Liabilities Large Commercial Banks	Amount Outstanding 4/9/86	Change from 4/2/86	Change from 4/10/85 Dollar	Change from 4/10/85 Percent[7]
Loans, Leases and Investments[1,2]	201,519	– 845	11,256	5.9
Loans and Leases[1,6]	182,979	– 908	10,681	6.1
Commercial and Industrial	52,590	– 610	– 257	– 0.4
Real estate	66,571	9	3,823	6.0
Loans to Individuals	38,846	– 83	5,481	16.4
Leases	5,655	31	292	5.4
U.S. Treasury and Agency Securities[2]	10,662	62	– 377	– 3.4
Other Securities[2]	7,878	1	951	13.7
Total Deposits	203,668	–1,529	6,508	3.3
Demand Deposits	49,852	–1,666	3,276	7.0
Demand Deposits Adjusted[3]	34,690	217	4,409	14.5
Other Transaction Balances[4]	16,492	243	2,336	16.5
Total Non-Transaction Balances[6]	137,324	– 106	897	0.6
Money Market Deposit Accounts—Total	46,476	80	2,419	5.4
Time Deposits in Amounts of $100,000 or more	37,069	– 132	– 1,680	– 4.3
Other Liabilities for Borrowed Money[5]	25,647	–1,703	5,349	26.3

Two Week Averages of Daily Figures	Period ended 4/7/86	Period ended 3/24/86
Reserve Position, All Reporting Banks		
Excess Reserves (+)/Deficiency (–)	– 3	135
Borrowings	17	10
Net free reserves (+)/Net borrowed(–)	– 20	125

[1] Includes loss reserves, unearned income, excludes interbank loans
[2] Excludes trading account securities
[3] Excludes U.S. government and depository institution deposits and cash items
[4] ATS, NOW, Super NOW and savings accounts with telephone transfers
[5] Includes borrowing via FRB, TT&L notes, Fed Funds, RPs and other sources
[6] Includes items not shown separately
[7] Annualized percent change