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May 13, 2011

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

Re: Prohibition Against Payment of Interest on Demand Deposits (Docket No. R-1413 and RIN No. 7100-AD72)

Dear Ms. Johnson:

The Investment Company Institute¹ appreciates the opportunity to comment on the Federal Reserve Board's proposed rule that would repeal Regulation Q, which prohibits member banks of the Federal Reserve System from paying interest on demand deposits.² The proposed rule, which implements Section 627 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), repeals Section 19(i) of the Federal Reserve Act, the statutory authority under which the Board established Regulation Q. In its rule proposal, the Board asked a series of questions about the repeal of Regulation Q, including whether it would have implications for money market funds.

ICI and its members are committed to working with policymakers to bolster policies that promote a well-functioning financial system. It is unclear how significant the competitive effect of allowing banks to pay interest on demand deposits will be on investor demand for money market funds, in part because banks already pay implicit interest on certain business demand deposit accounts (DDAs) through "earnings credits." We have deep concerns, however, that the elimination of Regulation Q, coupled with the unlimited deposit insurance on noninterest-bearing transaction accounts as required under Section 343 of the Dodd-Frank Act,³ will effectively extend unlimited

¹ The Investment Company Institute is the national association of U.S. investment companies, including mutual funds, closed-end funds, exchange-traded funds (ETFs), and unit investment trusts (UITs). ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of funds, their shareholders, directors, and advisers. Members of ICI manage total assets of \$13.1 trillion and serve over 90 million shareholders.

² See Prohibition Against Paying of Interest on Demand Deposits, Federal Reserve Board, Docket No. R-1413, RIN No. 7100-AD72 (April 5, 2011), available on the Board's website at <http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20110406a1.pdf>.

³ Pursuant to Section 343 of the Dodd-Frank Act, the FDIC is required to provide unlimited insurance coverage for funds held in noninterest bearing transaction accounts through December 31, 2012. See Deposit Insurance Regulations;

insurance to interest-bearing accounts. These changes could dramatically alter the competitive landscape between banks and money market funds and potentially create large outflows from money market funds and into banks either immediately or during a future financial crisis, putting severe pressure on the money markets.⁴ Furthermore, the combination of these two changes will significantly increase moral hazard for the banking system, and potentially increase the costs of operating the deposit insurance program for the FDIC and ultimately the U.S. taxpayer. Indeed, the adoption of these two provisions likely will create systemic risks that did not previously exist. It is important, therefore, that the unlimited insurance, authorized for two years in Section 343, be allowed to expire as contemplated by the Dodd-Frank Act.

Repeal of Regulation Q and its Effect on Money Market Funds

Regulation Q was put in place by the Glass-Steagall Act of 1933 as part of a Congressional response to banking practices and problems encountered during the Depression. It authorized the Board to set the rates of interest that banks would be allowed to pay their customers, including a rate of zero on DDAs. From the mid-1960s to the mid-1980s, yields on money market instruments generally were significantly higher than the imposed zero rate that banks were allowed to pay on DDAs and also were often higher than the ceiling imposed on passbook savings accounts. Among other things, these developments discriminated against investors with modest balances.⁵ When market interest rates were above deposit ceiling rates, wealthy investors, including institutions, were able to shift from deposits to direct investments in money market securities such as repurchase agreements or commercial paper. Smaller investors were forced to continue to hold their liquid balances in deposit accounts paying sub-market yields. Money market funds provided a conduit through which smaller investors could, for the first time, gain access to the higher yields available on open market instruments. For institutional investors, through asset pooling, money market funds often provided more efficient cash management and better diversification than direct investments in money market instruments. These funds also provided investors with larger balances with a cash-management tool that reduced their exposure to a single bank.

With the notable exception of prohibiting the payment of interest on DDAs, Regulation Q restrictions on deposit rates were gradually phased out in the 1980s, allowing depositories to compete

Unlimited Coverage for Noninterest Bearing Transaction Accounts, 75 Fed. Reg. 69,577 (November 15, 2010) (to be codified at 12 C.F.R. pt. 330).

⁴ In addition to these changes, forthcoming Basel III regulations that require banks to include credit commitments in their liquidity, net stable funding, and other calculations, may encourage banks to lure investors out of money market funds and into deposit accounts in order to strengthen their balance sheets. *See* Basel III: A global regulatory framework for more resilient banks and banking systems, Annex 4 (Basel Committee on Banking Supervision, December 2010).

⁵ *See* R. Alton Gilbert, "Requiem for Regulation Q: What It Did and Why It Passed Away," *Federal Reserve Bank of St. Louis Review* (February 1986) at 22-37.

more effectively by creating new products.⁶ In the retail space, these products included negotiable order of withdrawal accounts and money market deposit accounts, which are not considered DDAs. Banks have used sweep accounts to provide interest to business customers. Under such arrangements, banks allow customers to keep zero balances overnight in DDAs and sweep customer funds into repurchase agreements, money market funds, and offshore deposits daily. Banks also have been able to compete for business deposits by providing “earnings credits” on DDAs that can be used to offset service charges generated by the business account owner. These earnings credits amount to the implicit payment of interest on DDAs. The earnings credit rate, however, is reportedly sometimes less than that offered by a “hard” interest-earning account and any unused earnings credits typically do not carry forward from month to month. The repeal of Regulation Q, therefore, may make DDAs a more appealing alternative for business cash management, thereby potentially reducing demand for money market funds, sweeps, or other arrangements.

The effect of repealing Regulation Q on investor demand for money market funds, however, likely will be tempered by the tremendous benefits and protections money market funds provide to investors. Institutional investors historically have been attracted to money market funds not only for their market-based yields, but also for the unique protections offered by Rule 2a-7 under the Investment Company Act of 1940. Rule 2a-7, which was further strengthened in 2010, contains several conditions designed to limit a money market fund’s exposure to certain market risks by specifying strict limits on portfolio credit quality and maturity of portfolio securities, and requiring readily available liquidity for redemptions.⁷ In addition, the rule requires that money market funds maintain a diversified portfolio designed to limit a fund’s exposure to the credit risk of any single issuer. Indeed, money market funds often invest in hundreds of different underlying securities, providing investors with diversification across a large number of nonfinancial and financial institutions.

In contrast, banks depositors are protected against losses by bank capital and through insurance by the FDIC up to \$250,000 per account. Institutional investors, however, often manage cash balances totaling millions to hundreds of millions of dollars or more. For such investors, the repeal of Regulation Q may be an insufficient incentive to offset the risks of an undiversified exposure of deposits in a single bank compared to the more diversified investment available through a money market fund. Thus, it is difficult to predict with any degree of precision what effect the repeal of Regulation Q, in and of itself, will have on investor demand for money market funds. As discussed below, however, the balance between the different approaches of money market funds and banks could be dramatically

⁶ Regulation Q ceilings for savings accounts were phased out in 1986 by the Depository Institutions Deregulation and Monetary Control Act of 1980.

⁷ For more information on Rule 2a-7’s risk-limiting conditions, *see* Letter from Paul Schott Stevens, President and CEO, Investment Company Institute, to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, January 10, 2011 at 19-22 (ICI’s comment letter on the President’s Working Group report on money market fund reform options). In addition, a chart comparing money market fund regulations before and after the recent amendments to Rule 2a-7 is available on ICI’s website at http://www.ici.org/policy/regulation/products/money_market/11_mmf_reg_summ.

altered, as the risks associated with the lack of diversification in DDAs are mitigated by the availability of unlimited insurance on noninterest-bearing transaction accounts.

Effect of Unlimited Deposit Insurance on Noninterest-Bearing DDAs

The economic role of a carefully designed deposit insurance program is to help promote stability across the entire economy. Deposit insurance reduces the probability of bank runs by guaranteeing that retail depositors are made whole when a bank defaults.

Despite its demonstrated benefits, deposit insurance also carries risks for the financial system. For example, deposit insurance reduces the incentives for insured depositors to monitor the creditworthiness of banks, which in turn creates moral hazard that encourages banks to take additional risks, knowing that depositors will not withdraw their deposits if the bank's financial condition deteriorates.⁸ In addition, deposit insurance can cause other systemic risks for financial markets by increasing the propensity for investors to sell off assets—such as stocks, bonds, mutual fund shares, and other securities—and move the proceeds into insured deposits. As the FDIC itself has previously observed, this behavior can produce or exacerbate broader market dislocations during periods of financial stress.⁹

Historically, the risks posed by deposit insurance programs have been mitigated by capping the amount of a depositor's account that is insured (currently \$250,000).¹⁰ In the case of the temporary unlimited insurance authorized by Section 343 of the Dodd-Frank Act, even with the statutory limits on the types of accounts covered (noninterest bearing), the moral hazard and systemic risks created by the banking system have increased, particularly with the removal of Regulation Q.¹¹ For example, we

⁸ See, e.g., Federal Deposit Insurance Corporation, *The Deposit Insurance Funds: Options Paper* (August 2000), available at <http://www.fdic.gov/deposit/insurance/initiative/optionpaper.html> ("2000 Options Paper") (recognizing that "deposit insurance can create moral hazard and increase the risk and cost of failure if deposit insurance premiums do not fully compensate the FDIC for increases in risk posed by particular banks and thrifts. By assuming the risk of loss that would otherwise be borne by depositors, deposit insurance eliminates any incentive for depositors who are fully insured to monitor bank or thrift risk, thus reducing what is known as "depositor discipline." Management can therefore take greater risks without increasing the depository institution's cost of funds.").

⁹ See *id.* ("There is also the possibility of a large shift of household assets into insured deposit accounts in the event of financial market volatility. There is currently more than \$11 trillion outstanding in U.S. equity holdings (including mutual fund shares) alone. In a protracted bear market, some of these funds could be transferred to insured deposits."). See also Alan S. Blinder and R. Glenn Hubbard, *Blanket Deposit Insurance is a Bad Idea*, *WSJ Asia* (October 16, 2008) (arguing that 100 percent federal deposit insurance would pull funds out of other assets, including money market funds and other money market instruments, as well as out of other countries, as occurred when deposits flowed from Britain to Ireland after Ireland instituted a deposit guarantee in 2008).

¹⁰ See 2000 Options Paper, *supra* note 7 ("The coverage limit represents a balance between the goals of deposit insurance, on the one hand, and the need to limit moral hazard and the risk to taxpayers and the insurance funds, on the other.").

¹¹ For example, in proposing a limited extension of the Transaction Account Guarantee program (TAGP)—a program similar to Section 343—beyond its earlier termination date of June 30, 2010, the FDIC noted that it was seeking to "maintain stability for [insured depository institutions] and to promote a continued and sustainable economic recovery. . . ."

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are not aware of any limitation placed on interest-bearing DDA holders that would prohibit them from moving their cash balances to a noninterest-bearing, fully insured transaction account during a period of financial stress at an individual bank or in the financial markets in general. Nor are we aware of any prohibition on banks creating such a linkage that could be executed automatically. Taken together, the removal of Regulation Q and the unlimited insurance on noninterest-bearing transaction accounts required under Section 343 of the Dodd-Frank Act will effectively allow the FDIC to provide unlimited insurance on interest-bearing accounts and will no doubt draw money away from money market funds, other cash pools, and direct investments in the money market, perhaps even to a degree that could raise systemic concerns.¹² It is critical, therefore, that the unlimited insurance on noninterest-bearing transaction accounts, authorized for two years in Section 343, be allowed to expire as contemplated by the Dodd-Frank Act. Indeed, this point is sufficiently important that we recommend the Board express this view to Congress and the FDIC to ensure that the unlimited insurance is not extended by statute or regulation.

* * *

ICI appreciates the Board's attention to our comments. If you have any questions, please feel free to contact me directly at (202) 326-5917 or Karrie McMillan, ICI's General Counsel, at (202) 326-5815.

Sincerely,

/s/ Brian Reid

Brian Reid
Chief Economist

See Amendment of the Temporary Liquidity Guarantee Program to Extend the Transactions Account Guarantee Program with an Opportunity to Opt Out, 75 Fed. Reg. 20257, 20259 (April 19, 2010). The FDIC expressed its belief that a continuation of the TAGP would "help maintain community banks' ability to compete for and secure low cost large deposits, thereby preserving deposit franchise value and supporting the rebuilding of earnings and capital." *Id.*

¹² ICI pointed to similar concerns and risks associated with any potential unlimited federal guarantee of assets invested in money market funds, notably the risk of exacerbating the financial crisis by drawing large sums of deposits away from banks. See Investment Company Institute, *Report of the Money Market Working Group*, March 17, 2009 ("MMWG Report"), at 64-65. As noted in the MMWG Report, these risks are not theoretical. As a result, during the development in September 2008 of the Treasury Department's Money Market Fund Guarantee Program, ICI was a strong proponent of limiting the coverage of that program.