CONGRESSIONAL BUDGET OFFICE
COST ESTIMATE

March 27, 2003

H.R. 758
Business Checking Freedom Act of 2003

As ordered reported by the House Committee on Financial Services on March 13, 2003

SUMMARY

H.R. 758, the Business Checking Freedom Act of 2003, would allow depository institutions to pay interest on business demand deposit accounts and permit the Federal Reserve System to pay interest on any reserve balances held on deposit at the Federal Reserve by insured depository institutions. The Federal Reserve Board would also be given greater flexibility in setting reserve requirements and would be required to submit an annual report to the Congress summarizing many of the services provided and fees charged to consumers by depository institutions. The Federal Reserve would also be authorized to pay interest on contractual clearing balances, instead of only providing credits that can be used to pay the costs of the services it provides to depository institutions. The reduction in revenues as a result of the interest payments on reserves would be offset through 2007 by transfers from surplus funds of Federal Reserve Banks to the U.S. Treasury.

CBO estimates that the bill would not have any net effect on annual revenues over the 2004-2007 period because the estimated loss in revenues would be offset by transfers from Federal Reserve surplus funds. Enacting H.R. 758 would decrease revenues after 2007. CBO estimates that the loss in revenues would total approximately $1.5 billion over the 2008-2013 period.

H.R. 758 would not affect federal spending. It contains no intergovernmental or private-sector mandates as defined in the Unfunded Mandates Reform Act (UMRA) and would impose no costs on state, local, or tribal governments.

ESTIMATED COST TO THE FEDERAL GOVERNMENT

The estimated budgetary impact of H.R. 758 is shown in the following table.

	By Fiscal Year, in Millions of Dollars					
	2003	2004	2005	2006	2007	2008
CHANGES IN REVENUES						
Allowing Interest on Reserves	0	-92	-132	-115	-128	-141
Surplus Transfer to the Treasury	0	92	132	115	128	-466
Net Budgetary Effect	0	0	0	0	0	-608

The initial budgetary effect of H.R. 758 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 is expected to decrease the Federal Reserve's profits and thereby reduce federal revenues by $608 million over the 2004-2008 period. This budgetary response has several 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 (and interest payments on business demand deposit accounts) by shifting funds out of consumer "retail" and business "wholesale" 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 it 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. The legislation also stipulates that the overall revenue loss would be offset by a transfer from surplus funds of Federal Reserve banks to the U.S. Treasury for each fiscal year through 2007. Revenues losses would therefore commence in 2008.

BASIS OF ESTIMATE

The estimates are based on the assumption that the provisions would become effective early in fiscal year 2004, unless otherwise specified.

The Allowance of Interest on Reserve Balances

H.R. 758 would permit the Federal Reserve to pay interest on balances held on deposit at the Federal Reserve. 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 last decade from under $2 billion in 1990 to roughly $10 billion today. Excess reserves are funds held at reserve banks in excess of a depository institution's required reserve and contractual clearing balances. Staff at the Federal Reserve have indicated that, given the authority, the Federal Reserve would pay interest on *required reserve* balances and give depository institutions the option of earning an explicit rate of interest on *contractual clearing* balances or continuing with the current system of earning an interest credit. (The payment of interest on *required reserve* balances and the payment of interest on *contractual clearing* balances are discussed separately in this estimate, since their effects on revenues are likely to be different.) The Federal Reserve would choose not to pay interest on *excess* reserve balances, unless required reserve balances fell to such a low level that interest on excess reserves was needed to build reserves. That is considered to be an unlikely scenario.

Interest on Required Reserve Balances. The budgetary effect of interest on required reserve balances is divided into three components. First, the bill would result in the Federal Reserve paying interest on the required reserve balances expected under current law, reducing its net income and, therefore, governmental receipts. Second, the payment of interest on reserves would cause demand balances at depository institutions to increase. That increase would raise the level of reserve balances held at the Federal Reserve, although the increase would likely be diminished by Federal Reserve actions to reduce reserve

requirements. The higher reserve balances at the Federal Reserve would increase its earnings because it would invest the higher balances at a higher rate than it would pay on them. This change in projected reserves would increase governmental receipts, but only partially offset the loss caused by the payment of interest on reserves projected under current law. Third, the net reduction in Federal Reserve receipts from the first two effects would be partially offset by increased income and payroll tax receipts.

	Allowing Interest on Reserve Balances (By Fiscal Year, in Millions of Dollars)					
	2003	2004	2005	2006	2007	2008
CHANGES IN REVENUES						
Revenue from Federal Reserve:						
Interest on Required Reserves	0	-223	-252	-255	-269	-283
Profits from Increased Reserves	0	101	77	101	98	95
Net Effect on Revenue from Federal Reserve	0	-122	-175	-154	-170	-188
Income and Payroll Tax Offsets	0	31	44	38	43	47
Net Effect of Allowing Interest on Reserves	0	-92	-132	-115	-128	-141

Note: Totals may not sum due to rounding.

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 have since fallen sharply to around $7 billion or $8 billion today. The expansion of consumer and business 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 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. Recent advances in computer technology have now 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 and required reserve balances to decline further to about $5 billion over the next two years. Thereafter, CBO projects them to rise gradually with growth in the economy.

Under H.R. 758, 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 and clearing balances at a rate of 10 to 15 basis points below the federal funds rate.

CBO projects that the federal funds rate will average about 3.8 percent in 2004 and 5.1 percent over the 10-year period from 2004 through 2013. The payment of interest on reserves is assumed to start early in fiscal year 2004. CBO projects that H.R. 758 would cause the Federal Reserve to pay interest to depository institutions of about $223 million in 2004 on the $6 billion of required reserve balances expected under current law. Over the 2004-2008 period, 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.

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, 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. The payment of interest on business demand deposit accounts coupled with the payment of interest on reserves gives both businesses and depository institutions an incentive to open business checking accounts and close wholesale sweep accounts. Under current law, depository institutions are already allowed to pay interest on consumer demand deposits. By closing a significant share of consumer and business 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.

CBO assumes that depository institutions would eliminate approximately 30 percent of both retail and business sweep accounts currently in existence by 2006, and half of those that otherwise would be established. Although the payment of interest on business demand deposits by depository institutions would not be permitted until two years after enactment of H.R. 758, the bill would allow businesses to establish interest-bearing transaction accounts. Businesses would be allowed up to 24 transfers per month (or more if the Federal Reserve permits) into a demand deposit account that would be subject to reserve requirements. Because reserve requirements would also apply to those accounts, they would

be similar to interest-bearing demand deposits. As a result of the closings of retail and business sweep accounts, 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. H.R. 758 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 the 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. H.R. 758 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 we assume that required reserves would be maintained at roughly $20 billion to $25 billion, compared to $7 billion to $8 billion currently. That would require reductions in reserve requirements starting in 2006.

As a result, CBO projects that required reserve balances would increase above the level expected under current law and 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 in excess of that which it pays. As a result of the rate differential, the Federal Reserve would generate additional profits of about $101 million in 2004 and $472 million over the 2004-2008 period. The Federal Reserve would remit those profits to the Treasury as governmental receipts.

Projected Offsetting Impact on Tax Revenues. Allowing interest on required reserve balances held at the Federal Reserve would have a third budgetary effect that 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, generates 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 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 $122 million in 2004, offset partially by an increase in income and payroll taxes of $31 million. Over the 2004-2008 period, the loss in Federal Reserve receipts would total $810 million and the increase in income and payroll taxes would total $203 million.

The Allowance of Interest on Contractual Clearing Balances. Staff at the Federal Reserve have indicated that, given the authority, the Federal Reserve would give depository institutions the option of earning an explicit interest payment on contractual clearing balances or continuing with the current system of earning an implicit interest payment in the form of an interest credit, which can be used to offset fees for services provided by the Federal Reserve. CBO estimates that giving depository institutions the option of earning an explicit rate of interest on contractual clearing balances would have little or no budgetary effect.

For those depository institutions choosing an explicit interest payment on contractual balances, the explicit interest earnings, for the most part, would be substituted for what is now an implicit interest payment. Earning an explicit rate of interest on contractual balances may give some depository institutions an incentive to hold somewhat higher balances than currently because the interest credit earned under the present system can only be used to offset user fees for services provided by the Federal Reserve. A number of banks are already able to cover all of their service costs this way, so that an explicit interest payment is required to give them an incentive to hold more balances. As with required reserve balances, the Federal Reserve would pay an interest rate near the federal funds rate on these additional contractual balances and invest the funds in Treasury securities, which normally earn a higher return. The difference between what the Federal Reserve pays in interest on these additional balances and what it earns by investing them in Treasury securities would result in an increase in Federal Reserve earnings. Depository institutions, however, may choose to increase their contractual clearing balances by reducing the excess reserve balances they hold at the Federal Reserve. The Federal Reserve currently pays zero interest on excess reserves and invests them in Treasury securities, remitting these earnings to the Treasury. The additional earnings on contractual clearing balances could be completely offset, or possibly more than offset, depending on the extent to which depository institutions choose to increase their clearing balances by reducing their excess reserve balances. For example, if clearing balances increase by $2 billion and the rate differential between the federal funds rate and Treasury securities is 0.50 percentage points, then Federal Reserve earnings would increase by $10 million. If, however, $200 million of the increase in clearing balances was the result of a transfer from excess reserves by depository institutions, then, assuming a rate of return on Treasury securities of 5 percent, Federal Reserve earnings would not change because the $10 million increase in earnings would be offset by a decline of $10 million from the investment of excess reserves. CBO, therefore, estimates that making explicit interest

payments on contractual clearing balances is likely to have little or no significant effect on earnings.

Transfer from Surplus Funds of the Federal Reserve

During the first four years that H.R. 758 would be effective (fiscal years 2004 through 2007), the legislation provides that the revenue loss associated with allowing interest payments on reserve balances would be offset by requiring the Federal Reserve to remit from its surplus fund to the Treasury an amount equal to an estimate of the annual net revenue loss. In addition, during this same period, the bill would make the Federal Reserve payment of net earnings to the Treasury mandatory and the Federal Reserve would not be allowed to replenish its surplus fund. Those provisions would have the effect of reducing the cost of the legislation to zero through 2007 and postpone the accumulated net revenue loss to the federal government until 2008.

Out of its annual earnings, the Federal Reserve covers its operating costs, pays a small dividend to its member banks, retains monies for its surplus fund, and voluntarily remits the remaining profits to the U.S. Treasury. The Federal Reserve's surplus fund is a stock of retained earnings accumulated over time and is set by the Federal Reserve each year at a level equal to the paid-in capital of its member banks. The fund can be used as collateral for issuance of Federal Reserve notes and may be viewed as a fiscal cushion. The surplus funds are invested in Treasury securities and the interest generated is remitted to the Treasury along with other profits of the Federal Reserve.

During the period through 2007, H.R. 758 would direct the Federal Reserve to remit to the Treasury all of its earnings above its member bank dividend payments, additions to its surplus account, and operating costs, which would now include interest paid on reserves. In addition, it would be required to remit from its surplus fund an amount equal to the estimated cost of paying interest on reserves. The Federal Reserve would be prevented from replenishing its surplus fund by the amount of these transfers through 2007 and its payment of net earnings to the Treasury would be mandatory. In fiscal year 2008, however, the Federal Reserve would be expected to replenish its surplus fund by the entire amount that was transferred from the fund to the Treasury during the 2004-2007 period, an estimated $466 million. This response is anticipated because the Federal Reserve has replenished its surplus account at its first available opportunity when transfers from the surplus fund have been mandated in the past. The legislated surplus fund transfer under H.R. 758, therefore, would postpone until 2008 the accumulated net revenue loss to the Treasury during the period from 2004 to 2007. CBO estimates that the revenue loss in fiscal year 2008 would be about $608 million. The Federal Reserve would be expected to retain $466 million out of its earnings to replenish its surplus fund instead of remitting these profits to the Treasury. The remaining $141 million is the estimated net revenue loss from making interest payments

on reserve balances for that year. CBO estimates that the resulting revenue loss for the 2008-2013 period would be about $1.5 billion.

The transfer of the surplus funds would not reduce the cost of the bill to the federal government over the long term; it would just postpone it. It also is important to note that the transfer of surplus funds from the Federal Reserve to the Treasury has no import for the fiscal status of the federal government. If the surplus funds are held at the Federal Reserve, they are invested in government securities and the interest generated is remitted to the Treasury. If the surplus funds are transferred to the Treasury instead, they reduce the public debt and in turn the interest payments owed by the Treasury. Since the interest payments would be identical in either case, where the funds reside has no *economic* significance. Hence, any transfer of the Federal Reserve surplus fund to the Treasury would have no effect on national savings, economic growth, or income.

Payment of Interest on Business Demand Deposit Accounts

Allowing depository institutions to pay interest on business demand deposit accounts would, in itself, have the effect of increasing demand deposit accounts at depository institutions, although CBO estimates that this effect would not be significant without the additional provision of allowing interest on required reserves. Depository institutions that do not currently offer commercial sweep accounts would offer interest-bearing business demand deposit accounts, and businesses that currently have sweep accounts would have an incentive to hold higher levels of demand deposits with the allowance of interest on business demand deposits. Required reserves held at the Federal Reserve would increase with the rise in the level of demand deposits, increasing the earnings of the Federal Reserve and the amount that is remitted to the Treasury as governmental receipts. CBO, however, estimates that the revenue effect of that increase in required reserves would be negligible and that it is the combined effect of the payment of interest on reserves and the allowance of interest on business demand deposit accounts that would result in the revenue loss described above.

Provisions in the Bill Estimated To Have An Insignificant Budgetary Effect

The bill would require the Federal Reserve to conduct a survey of insured depository institutions and credit unions and submit an annual report to the Congress on the availability and cost of banking services. Based on information provided by staff at the Federal Reserve, CBO estimates that the additional costs to the Federal Reserve would be insignificant. In addition, based on information from the Federal Deposit Insurance Corporation, CBO estimates that the bill would have no significant impact on the total balance of insured deposits or the likelihood that some institutions would fail and, therefore, would have no significant impact on federal spending.

ESTIMATED IMPACT ON REVENUES AND DIRECT SPENDING

CBO's estimate of the net effect of H.R. 758 on revenues and direct spending over the 2003-2013 period is shown in the table below.

	By Fiscal Year, in Millions of Dollars										
	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
Changes in receipts	0	0	0	0	0	-608	-152	-163	-175	-187	-200
Changes in outlays	0	0	0	0	0	0	0	0	0	0	0

ESTIMATED IMPACT ON STATE, LOCAL, AND TRIBAL GOVERNMENTS

H.R. 758 contains no intergovernmental mandates as defined in UMRA and would impose no costs on state, local, or tribal governments.

ESTIMATED IMPACT ON THE PRIVATE SECTOR

The bill would authorize the Board of Governors of the Federal Reserve System (FRB) to prescribe regulations concerning the responsibilities of correspondent banks that maintain balances at the Federal Reserve on behalf of other institutions. Such private institutions as commercial banks, Federal Home Loan Banks, and corporate credit unions serve as correspondent banks for many depository institutions that are not members of the Federal Reserve. Based on information provided by the FRB, CBO anticipates that the Board of Governors would not use its authority to issue regulations unless problems arose in the crediting and distribution of interest earnings. Thus, CBO expects that this bill would not impose a mandate on the private sector. If after a period of time the FRB determined a rule was necessary, the FRB indicates the rule could require correspondent banks to pass the interest earnings back to the institutions for which they maintain required reserves at the Federal Reserve. The cost to the correspondent banks of complying with such a rule would be negligible.

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