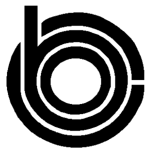

CONGRESSIONAL BUDGET OFFICE
COST ESTIMATE

September 14, 1998

S. 1405
The Financial Regulatory Relief and Economic Efficiency Act of 1998

As ordered reported by the Senate Committee on Banking, Housing, and Urban Affairs on July 30, 1998

SUMMARY

S. 1405 would make numerous changes to the relationship between financial institutions and the federal agencies that are responsible for regulatory and monetary policy. Most significantly, the bill would permit the Federal Reserve System to pay interest on reserves held on deposit at the Federal Reserve, and it would repeal the provision of law that prohibits depository institutions from paying interest on commercial demand deposits. The bill also would transfer the health coverage of retirees and certain active employees of the Federal Deposit Insurance Corporation (FDIC) and the Federal Reserve System to the Federal Employees Health Benefits (FEHB) program. In addition, the bill would eliminate the requirement for the FDIC to establish a "special reserve" for the Savings Association Insurance Fund (SAIF) and it would raise the pay of the Chairman and six other members of the Board of Governors of the Federal Reserve System.

CBO estimates that the bill would reduce federal revenues by $575 million and direct spending by $54 million over the period from 1999 through 2003. Consequently, pay-as-you-go procedures would apply to the legislation. The provisions regarding interest on reserves account for most of the budgetary effect, with the rest coming from the provisions that would transfer the health insurance coverage of certain employees. The provisions to remove the requirement that the FDIC establish the SAIF reserve and to raise the pay for the Board of Governors of the Federal Reserve System are estimated to have an insignificant budgetary effect. CBO estimates that no significant budgetary effects would result from the remaining provisions, which largely clarify or streamline certain rules and procedures.

S. 1405 contains no intergovernmental mandates as defined in the Unfunded Mandates Reform Act (UMRA) and would have no significant effects on the budgets of state, local, or tribal governments. S. 1405 would, however, impose a private-sector mandate as defined

by UMRA by requiring indenture trustees to mail forms once a year to holders of indenture securities requesting change of address information. For reasons described below, it is unlikely that the direct costs of this mandate would exceed the statutory threshold established in UMRA ($100 million in 1996, adjusted annually for inflation), although CBO cannot make that determination with confidence. The bill would also change existing laws in ways that could lower the costs to depository institutions of complying with existing federal requirements.

ESTIMATED COST TO THE FEDERAL GOVERNMENT

The estimated budgetary impact of S. 1405 is shown in the following table.

	By Fiscal Year, in Millions of Dollars					
	1999	2000	2001	2002	2003	2004-2008
CHANGES IN DIRECT SPENDING						
FDIC						
Estimated Budget Authority	0	0	0	0	0	0
Estimated Outlays	160	-14	-15	-18	-20	-144
FEHB Program						
Estimated Budget Authority	-178	6	7	8	10	58
Estimated Outlays	-178	6	7	8	10	58
Total, Direct Spending						
Estimated Budget Authority	-178	6	7	8	10	58
Estimated Outlays	-18	-8	-8	-10	-10	-86
CHANGES IN REVENUES						
Interest on Required Reserves and Business Demand Deposits	-145	-116	-98	-102	-107	-609
Shift of Federal Reserve Employees and Retirees to FEHB Program	-11	1	1	1	1	5
Total, Revenues	-156	-115	-97	-101	-106	-604

NOTE: FDIC=Federal Deposit Insurance Corporation; FEHB program=Federal Employees Health Benefits program.

The source of the largest budgetary effect of S. 1405 is the federal payment based on the profits of the Federal Reserve System. The Federal Reserve remits its profits to the Treasury, and those payments are classified as governmental receipts, or revenue, 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 comprise the bulk of its liabilities. Since the Federal Reserve pays no interest on reserves or currency, and the Treasury Department 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, according to CBO's analysis, would reduce the Federal Reserve's profits and thereby reduce federal revenues by $568 million over the period from 1999 to 2003. The estimate includes an anticipated response by depository institutions and depositors that would increase the amount of demand deposits and, therefore, required reserves. CBO estimates that this response would reduce, but not eliminate, the expected loss in federal revenues.

In addition, direct spending would decrease by an estimated $18 million in 1999, $8 million in both 2000 and 2001, and $10 million in both 2002 and 2003. The savings would result from the transfer of health coverage of retirees and certain active employees of the FDIC and the Federal Reserve System to the Federal Employees Health Benefits (FEHB) program. The shift would reduce costs because the health insurance the agencies currently provide these employees is more costly than health insurance under the FEHB program. Because the transfer would include the retirees and certain active employees of the Federal Reserve System, revenues would also be affected. The transfer would cause revenues to increase by $1 million per year from 2000 through 2003, but to decrease by $11 million in 1999.

BASIS OF ESTIMATE

The estimates assume that the provisions become effective at the beginning of fiscal year 1999, unless otherwise specified.

Paying Interest on Reserve Balances

S. 1405 would allow the Federal Reserve to pay interest on the reserves that depository institutions hold on deposit at the Federal Reserve ("required and excess reserve balances"). That payment would cause a shift in profits from the Federal Reserve to depository institutions that, on net, would reduce governmental receipts. The budgetary effect can be divided into two components. First, the bill would cause the Federal Reserve to pay interest

on the level of its required reserve balances expected under current law, reducing its net income and, therefore, governmental receipts. The reduced receipts would be offset only partially by increased corporate income tax receipts from the higher profits of depository institutions. Second, the payment of interest on reserves held at the Federal Reserve and on commercial demand deposits held at depository institutions would cause demand balances at depository institutions to increase. That increase would raise the level of reserve balances at the Federal Reserve, which would invest them at a rate higher than it would pay on them. This change in projected reserves would increase governmental receipts on net, but would only partially offset the loss caused by the payment of interest on reserves projected under current law.

Revenue Effect of Allowing Interest
on Reserve Balances
(By Fiscal Year, in Millions of Dollars)

	1999	2000	2001	2002	2003	2004-2008
Changes in Revenues						
Federal Reserve Revenue	-193	-155	-131	-136	-143	-812
Income Tax Revenue	48	39	33	34	36	203
Total, Revenue Effect	-145	-116	-98	-102	-107	-609

Interest Payments on Reserves Projected Under Current Law. Because depository institutions currently do not earn a return on 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 about $10 billion today. The widely-reported expansion of consumer sweep accounts has caused this recent decline. In typical sweep accounts, banks shift their depositors' funds from demand deposits, against which reserves are required, into other depository accounts, against which no reserves are 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 and have had the same effect of reducing required reserves. Recent advances in computer technology have now made the shifting of funds feasible for many consumer ("retail") accounts as well. Under current law, CBO expects the expansion of retail sweep accounts to continue and, based on its March 1998 baseline, required reserve balances to decline further to about $4.4 billion by 1999. Thereafter, CBO projects them to rise gradually with growth in the economy.

S. 1405 would permit the Federal Reserve to pay interest on reserve balances. The Federal Reserve would be allowed to choose the interest rate, although the rate chosen could not exceed the general level of short-term interest rates. The Federal Reserve has indicated that, given the authority, it would pay interest on required reserve balances and it would choose an interest rate near the key short-term rate, the federal funds rate. The rate likely would be roughly 10 basis points lower than the federal funds rate to account for the lack of risk. The Federal Reserve has indicated, however, that it would choose not to pay interest on excess reserves unless required reserve balances fell to such a low level that interest on excess reserves was needed in order to build reserves. CBO assumes, therefore, that the Federal Reserve would pay interest only on required reserves, at a rate near the federal funds rate. Based on its March 1998 baseline assumptions, CBO projects the federal funds rate to average about 5.7 percent in 1999 and decline to about 5.2 percent by 2001 and thereafter. CBO assumes that the payment of interest on reserves would start early in fiscal year 1999. CBO projects that the bill would cause the Federal Reserve to pay interest to depository institutions of about $250 million in 1999 on the $4.4 billion of required reserve balances expected under current law. Interest payments would decline to about $235 million in each of the following two years because of lower interest rates. Over the period from 1999 through 2003, interest payments would total about $1.2 billion. Those payments would reduce the profits of the Federal Reserve--and thus its payment to the Treasury--by the same amount.

Because receipts of interest by depository institutions presumably would increase their profits by the same amount that the Federal Reserve's profits declined, overall profits in the economy would remain unchanged. Assuming that depository institutions face a marginal tax rate on corporate income of 25 percent, we estimate that corporate income tax receipts would increase by about $60 million in 1999 and $300 million through 2003 as a result of the additional interest income. That increase in receipts would offset one-quarter of the reduction in governmental receipts from reduced Federal Reserve profits. Thus, the net revenue loss to the federal government from the interest payments with no change in projected reserves would be about $190 million in fiscal year 1999 and approximately $900 million over the period from 1999 through 2003.

It is possible that, instead of retaining the additional interest income, depository institutions would pass some of the increased profits through to their business and consumer customers by raising interest rates on deposits or lowering rates on loans. If a complete passthrough did occur, then the customers--not the depository institutions--would accrue the income and pay the additional taxes. The increase in income tax revenues would be roughly similar to that estimated without such a passthrough assumption.

Projected Impact of the Bill on the Volume of Reserves. If the Federal Reserve paid interest on required reserve balances and depository institutions were allowed to pay interest on business demand deposits, there would be a second budgetary effect 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. By doing so, the institutions could eliminate the costs of maintaining the sweep accounts and receive a return on their required reserves. However, closing the sweep accounts could reduce the earnings of banks because the return on required reserves--approximately the federal funds rate--likely would be lower than what they could receive with free use of the funds from the sweep accounts.

CBO assumes that by 2001, depository institutions would eliminate 30 percent of both retail and business sweep accounts currently in existence, and half of those that otherwise would be undertaken. Although S. 1405 would not permit the payment of interest on business demand deposits until after January 1, 2001, the bill would allow businesses to deposit funds in a new money market account (MMDA) upon enactment of the bill through July 1, 2001. Depositors in those accounts would receive interest and be permitted up to 24 transactions in any month. Because reserve requirements would also apply to those accounts, they would be similar in many ways to interest-bearing demand deposits. Despite the similarities, during this transition period CBO assumes a slower rate of closings of business sweep accounts than if interest were immediately allowed on business demand deposits. As a result of the closings of retail and business sweep account, demand deposits on which required reserves are calculated would increase at depository institutions. CBO therefore projects that required reserve balances would increase above the level expected under current law, by about $17 billion in 2001 and $19 billion by 2003.

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 in excess of the federal funds rate by an amount estimated at between 0.6 and 0.7 of a percentage point. As a result of the rate differential, the Federal Reserve would generate additional profits of $465 million through 2003 and return them to the Treasury as governmental receipts. Other corporate profits, including those of the firms that generate the computerized sweep account software and the depository institutions, would decline on net, however, by the same amount as the increase in the Federal Reserve's profits. (Again, overall profits in the economy would be unchanged.) The reduced profits of corporations would cause corporate income tax receipts to fall, assuming the same marginal tax rate as before of 25 percent, by about $115 million through 2003. The overall net effect of the added reserves would be to increase governmental receipts by about $45 million in 1999 and $350 million

over the 1999-2003 period. This effect, therefore, offsets about 40 percent of the five-year revenue loss estimated for the payment of interest assuming no change in projected reserves. The overall estimated budgetary effect of the provisions allowing interest on reserve balances and interest on commercial demand deposit accounts is a reduction in revenues of $145 million in 1999 and $568 million over the 1999-2003 period. Over the period from 2004 through 2008, the overall revenue loss would total $609 million, making the 10-year revenue loss total slightly less than $1.2 billion.

Health Insurance Transfer for Certain Employees

The bill would transfer the health insurance coverage of retirees and certain active employees of the FDIC and the Federal Reserve System to the Federal Employees Health Benefits program. These employees are currently covered by in-house health insurance plans. The legislation would also require the two agencies to make a one-time payment to the Office of Personnel Management (OPM), which administers the FEHB program, in order to cover the long-term cost of the government's contribution toward the insurance premiums of the newly covered individuals. CBO estimates that over the 1999-2003 period, overall direct spending would decline by $54 million and revenues would decline by $7 million as a result of the bill.

The shifting of the FDIC employees and retirees to the FEHB program would reduce direct spending in each year because the FDIC pays more for health insurance than the FEHB program would pay. The current FDIC plan is more expensive then the typical FEHB plan because the insured employees are older and fewer in number, and it provides more general coverage. Ongoing savings would grow from an estimated $7 million in fiscal year 1999 to $11 million in 2003. CBO assumes that the FDIC would make the required one-time payment to OPM in January 1999. We estimate that the one-time payment would be $170 million; but we also estimate that the FDIC would save $10 million in the same year from lower health insurance costs. The net cost to the FDIC in 1999, therefore, would be $160 million. Reflecting the transfer from the FDIC, the FEHB program would receive the payment of $170 million in that year but would incur additional costs of about $3 million to insure those employees and retirees, for net savings of $167 million to the FEHB program.

The transfers between the Federal Reserve and FEHB would have a similar effect, but significantly fewer employees would be affected at the Federal Reserve. We estimate that the Federal Reserve would make a one-time payment of $12 million to OPM in 1999, with associated savings of $1 million, for a net reduction in revenues of $11 million. The associated savings to the Federal Reserve and costs to the FEHB program beyond 1999 would both approximate $1 million per year, although the FEHB costs may be slightly less and the Federal Reserve's savings slightly more. Also, the budgetary effects on the Federal

Reserve are recorded on the revenue side of the budget. Thus, the resulting increases in federal revenues beyond 1999 would approximate the increases in FEHB costs for coverage of the Federal Reserve personnel, and the net budgetary impact each year would be negligible.

Special Reserve for SAIF

The bill would repeal the requirement for the Savings Association Insurance Fund (SAIF) to establish a special reserve fund. CBO expects that the cost of that repeal would total less than $500,000 in any year.

Under current law, on January 1, 1999, the Federal Deposit Insurance Corporation (FDIC) must set aside all balances in the SAIF that exceed the required reserve level of $1.25 per $100 of insured deposits. The reserve funds become available to pay for losses in failed institutions only if the SAIF reserve balance subsequently falls below 50 percent of the required reserve level, and the FDIC determines that it is expected to remain at that level for a year.

Currently, the SAIF reserve is about 1.36 percent of insured deposits, and CBO expects that by January 1999, about $1.1 billion would be available for transfer to the special reserve. At that point, the SAIF fund balance would drop to $1.25 per $100 of insured deposits. CBO's baseline assumes administrative costs and thrift failures would remain sufficiently low to avoid raising assessment rates on SAIF-insured institutions through 2003. We expect that SAIF would continue to earn interest on its remaining fund balances of over $9 billion in 1999, and that the fund ratio would slowly climb each year, reaching about 1.4 percent by 2003.

Although CBO baseline estimates do not assume that the cost of thrift failures in any year would exceed the net interest earned by the SAIF, unanticipated thrift failures could result in a drop in the SAIF fund reserve ratio below 1.25 percent. The baseline reflects CBO's best judgment as to the expected value of possible losses during a given year, but annual losses would likely vary from the levels assumed in the CBO baseline. Thus, some small probability exists that thrift failures could increase sufficiently to drive the reserve ratio below the required level of 1.25 percent, but not so low as to trigger use of the special reserve.

When the balance of an insurance fund balance dips below the required ratio, the FDIC is forced to increase assessments for deposit insurance to restore the fund balance to the required level. Thus, if thrift losses were to exceed baseline estimates by a significant

amount, we would expect the FDIC to increase insurance rates in order to maintain the SAIF's fund balance. Eliminating the special reserve would add to the fund balances and would make it less likely that the FDIC would have to raise insurance premiums. The probability that this change would affect premium rates is quite small, however, and therefore CBO expects that the cost of eliminating the special reserve would total less than $500,000 in any year.

PAY-AS-YOU-GO CONSIDERATIONS

The Balanced Budget and Emergency Deficit Control Act sets up pay-as-you-go procedures for legislation affecting direct spending or receipts. CBO estimates that S. 1405 would reduce receipts by $1.179 billion and outlays by $2 million over the period from 1999 through 2008. The projected changes in receipts and outlays are shown in the following table for fiscal years 1999 through 2008. For the purposes of enforcing pay-as-you-go procedures, only the effects in the current year, the budget year, and the succeeding four years are counted.

The budget excludes from pay-as-you-go calculations expenses associated with maintaining the deposit insurance commitment. CBO assumes that the budgetary effects of shifting the health insurance coverage of FDIC employees would be excluded from the pay-as-you-go calculation because they would be associated with maintaining the deposit insurance commitment. The budgetary effects on the Federal Reserve, and the corresponding effect on outlays of the FEHB, would not be excluded. Most of the effect on receipts is caused by the provision authorizing the Federal Reserve to pay interest on required reserves.

	By Fiscal Year, In Millions of Dollars									
	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008
Changes in outlays	-11	1	1	1	1	1	1	1	1	1
Changes in receipts	-156	-115	-97	-101	-106	-110	-115	-121	-126	-132

ESTIMATED IMPACT ON STATE, LOCAL, AND TRIBAL GOVERNMENTS

S. 1405 contains no intergovernmental mandates as defined in UMRA and would have no significant effects on the budgets of state, local, or tribal governments.

ESTIMATED IMPACT ON THE PRIVATE SECTOR

Corporate debt securities are often issued under, and controlled by, a trust indenture. An indenture is a contract that outlines the maturity date, interest rate, redemption rights, and other terms under which debt securities (in the form of bonds and debentures) are issued. The Trust Indenture Act of 1939 (TIA) requires that an indenture be executed by both the corporate issuer and a trustee who acts on behalf of bondholders. S. 1405 would impose a private-sector mandate by amending TIA so that once a year indenture trustees would have to mail each holder of an indenture security a form requesting change of address information. The bill would allow trustees to include the request form in other customary mailings under the Trust Indenture Act when possible.

Although it is unlikely that the direct costs of this private-sector mandate (net of savings) would exceed the statutory threshold for private-sector mandates ($100 million in 1996 dollars, adjusted annually for inflation), CBO cannot make that determination with confidence because of the uncertainties involved in identifying the number of beneficiaries who would have to be notified and the extent of the offsetting savings that would accrue to depository institutions from other provisions in the bill.

One of the difficulties that arise in estimating the number of beneficiaries occurs because the bill does not clearly define the term "indenture security holder." Based on discussions with congressional staff, industry experts, and the Securities and Exchange Commission, CBO concludes that the term may apply either to a relatively small group of registered security holders or to a significantly larger group of beneficial (individual) security holders. Most securities are not registered in the name of beneficial holders but are held in securities depositories for banks and brokerage firms that hold securities for their customers. Although it is clear that the first group is smaller and easier to contact than the other, CBO was unable to obtain adequate information on the number of security holders in either category. Since some experts estimate the average cost of a mailing and other administrative actions associated with obtaining change of address information to be about $5 per person, if the bill were to affect over 20 million beneficial security holders, it would exceed the cost threshold for private-sector mandates. However, if the indenture trustees only need to mail to registered

security holders, it is most likely that the net direct costs of the mandate would not exceed the threshold.

Many provisions in the bill would change existing laws in ways that could lower the costs to depository institutions of complying with existing federal requirements. The majority of trust indentures are handled by about 340 banks and thrifts. Those institutions could benefit from the changes the bill would make to reduce the burden of some existing regulations. Thus, the net direct cost of private-sector mandates imposed by the bill could easily fall below the threshold. However, CBO does not have enough information about how the benefits of cost-reduction provisions would be distributed to banks and thrifts to estimate the potential savings to institutions affected by the mandate.

S. 1405 would also authorize the Federal Reserve to pay interest on reserve balances held on deposit at the Federal Reserve. Along with the authority to pay interest on reserves, the bill would authorize the Board of Governors of the Federal Reserve System to prescribe regulations concerning the responsibilities of correspondent banks that maintain balances at the Federal Reserve on behalf of other institutions. 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 Board of Governors of the Federal Reserve System, CBO expects the Federal Reserve would not use its authority to issue regulations unless problems arose in the crediting and distribution of interest earnings. Thus, this provision would not impose a private-sector mandate as defined by UMRA. If, after a period of time, the Federal Reserve determined a rule was necessary, the rule would most likely require that correspondent banks pass the interest earnings back to the institutions for which they maintain required balances at the Federal Reserve. The cost to the correspondent banks of complying with such a rule would be negligible.

PREVIOUS CBO ESTIMATES

On June 1, 1998, CBO prepared a cost estimate for H.R. 1836, the Federal Employees Health Care Protection Act of 1998, as ordered reported by the Senate Committee on Governmental Affairs on April 1, 1998. It contained, among other provisions, the same transfer of health insurance as in S. 1405. The budgetary effects of those provisions cited in that estimate are identical to those included in this estimate of S. 1405.

On Sept. 5, 1997, CBO prepared a cost estimate for H.R. 2323, the Small Business Banking Act of 1997, as introduced on July 31, 1997. The bill would also authorize the Federal Reserve to pay interest on required reserves and depository institutions to pay interest on

business demand deposits. The budgetary effect of those provisions cited in the cost estimate for H.R. 2323 differs from that cited in this estimate of S. 1405, which incorporated more recent economic data and forecasts, additional research into the anticipated response of depositors and depository institutions, and a different effective date.

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