Dodd-Frank & Reg Q: To pay or not to pay?

Interest on business checking ban may go out with a whimper

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By Steve Cocheo, executive editor. This is an expanded and updated version of an article from the June 2011 ABA Banking Journal department “Bank Notes.”

In late May, Gerard Cuddy’s Beneficial Bank unveiled a major promotion offering interest on business checking, about two months before it becomes legal, again, under the Dodd-Frank Act. It wasn’t lost on Cuddy that Beneficial was straying several steps out of most of the industry’s path. In fact, it was intentional.

“We think it is the right thing to do, for the small business customer,” says Cuddy, president and CEO at the $4.7 billion-assets publicly traded savings institution. “I don’t know if everyone paying interest on business checking is inevitable, but we wanted to be the first out, to offer it.”

Beneficial has added the option of receiving interest on business checking to its existing business banking packages—it won’t actually start, of course, until the Dodd-Frank provision goes into effect on July 21. When it does begin, the interest payments will be tiered. In addition, customers will have a choice of explicit interest or earnings credits available already on accounts subject to formal relationship analysis.

Philadelphia’s Beneficial Bank takes an unusual tack on the demise of Regulation Q’s ban on business checking interest. It’s promoting the July 21 change.

Beyond offering this new feature, Beneficial is putting direct cash behind its offer. Any new business customer--the bank has made a point of aiming this at the “micro-business” segment—that opens one of two business package accounts will receive a $100 bonus. And any existing customer that refers a new business prospect to Beneficial will also receive that bonus. (Certain rules apply.)

Cuddy knows his bank is “out there,” and obviously hopes to make the most of it.

“Why aren’t other banks doing this for their customers?” asks Cuddy, rhetorically. “It doesn’t seem like a reach. It seems like a no brainer.”

No rush for the July 21 entrance

Beneficial may not be the only institution making an advance splash about interest on business checking, but based on the plans of a cross-section of community bankers interviewed, and what they are seeing and hearing in their markets, the Philadelphia bank very much is in the minority at this time. Even in his own competitive market, Cuddy says, there’s been not a peep from anybody else.

It’s not often that the reversal of a banking law going back to the Great Depression draws a mostly low-key reception from the banking industry.

But a combination of factors results in most community banks not making the oncoming repeal of restrictions on paying explicit interest on business demand deposits a priority.

Among the factors: Dodd-Frank overload; an overflowing plate of higher-priority tasks; a present abundance of deposits weighed against widespread low loan demand; an urge to not give up increasingly scarce fee income; an environment of ultra-low interest rates; and questions about the technical details behind the “simple” change. Add an interesting deposit insurance twist and you get something of an exhausted yawn in many quarters about the July 21 change. (You’ll hear more about this shortly.)

No one really knows quite what to expect, says Greg Judge, vice-president and consultant with the Bank Investment Group, LLC, of the Pacific Coast Bankers Bank. Even very large banks, with deep pockets and the ability to outlast smaller competitors, may not jump on this “opportunity,” though some watchers say they see glimmers. Judge points out that Bank of America and Wells Fargo, for instance, have huge amounts of corporate checking funds, and nobody (with Beneficial apparently an early exception), wants to pay anything for funds that they don’t have to.

Community banker Josh Guttau, formerly of a large regional bank, has been studying the issue and he suspects large banks will not be any more anxious than community banks to stand out.

“My gut tells me that they’ll use this new law for defense, not for offense,” says Guttau, president and CFO, at $211.3 million-assets Treynor State Bank, Treynor, Iowa. That’s publicly, at least, adds Guttau. Whether interest on checking is something that calling officers receive to keep in their back pocket, as a deal maker or clincher--that remains to be seen.

Consultant Michael Moebs frets that community banks are going to be hurt in the July 21 changeover, sooner or later, if they are sitting on the sidelines.

“Nobody seems to understand the importance of this,” says Moebs, who specializes in massive studies of bank account pricing and policies. He notes that credit unions have had the ability to pay business checking customers interest for some time, though they have done little with it. He worries that they are going to wake up and become more competitive, to grab business deposits and relationships.

“There are very few bankers doing anything about this,” Moebs continues. “I think they are leaving the door open for credit unions and other bankers.”

Quiet on the checking front

But many community bankers, while fully cognizant of the Dodd-Frank schedule, are not going to panic stations nor battle stations. Mind you, Dodd-Frank and the Federal Reserve’s proposed regulatory revisions don’t force this on banks. It’s optional.

“We will be restructuring and re-pricing all of our business checking account products this fall and will probably create the business checking with interest product at that time,” says Wyoming community banker Richard Chenoweth, at $146 million-assets Rawlings National Bank. Chenoweth says the bank has had no demand for the product from customers. “There are plenty of other, larger fish to fry, in dealing with this difficult economy,” he explains.

“Most of the banks that I’m talking to think of this as a nonevent,” says bank asset-liability management consultant George Darling. “The last thing most banks need right now is deposits. There’s no loan demand. And they don’t want to pay up for money they already have.” Adds Darling: “Nobody wants to be first.” (Again, with the exception of the likes of Beneficial.)

While Dodd-Frank lifts the restriction by statute on July 21, a year after the law’s enactment, most community bankers interviewed continue to study the matter. They say virtually no one—neither big bank nor community bank—has tipped their hand or tried to get out in front of the pack.

Indeed, “we are watching the market like hawks, but they are sitting quiet on this one,” says Dan Geller, executive vice-president of Market Rates Insight, a firm that tracks financial institutions deposit pricing.

Typical comments from bankers:

• “We’re looking at the options that are open to us,” says Frank Sorrentino, chairman and CEO, $602 million-assets North Jersey Community Bank, Englewood Cliffs. “But right now, I’m not so sure anybody cares, because interest rates are near 0%.”

• “I would have preferred that they didn’t change the rules,” says Rheo Brouillard, president and CEO, $915.2 million-assets Savings Institute Bank & Trust, Willimantic, Conn. “It has the potential to change the interest expense side. These have been good low-cost deposits for some time.”

• “Credit unions here in Oregon pay interest on business deposits and we have complained about our inability to compete with them,” says Portland banker Ann Marie Mehlum, president and CEO, $117.6 million-assets Summit Bank, Eugene. “That said, it will take a good deal of our management bandwidth to evaluate this and devise the best implementation strategy. We will not be ready in July.”

Meanwhile, consultant Moebs suggests that as rates rise, the issue of interest on checking will quickly become more important. He implies that banks shouldn’t waste too much time before addressing the Dodd-Frank changes.

“I now know how John the Baptist felt,” says Moebs, noting that recent speeches on this subject have failed to raise a reaction. “I’m a voice crying in the wilderness.”

Moebs does wish the banks had more time to get ready. Indeed, in a May 16 comment letter to the Federal Reserve, ABA—writing with The Clearinghouse—stated:

“Due to the repeal of Regulation Q, banks choosing to offer interest-bearing demand deposits will have an operational burden to develop new deposit products, update contracts and disclosures, educate customers, and, depending on the applicable FDIC insurance levels, move a substantial volume of customers’ funds into new deposit products. From a compliance perspective, banks need clarity on the treatment of new interest-bearing demand deposit accounts, including hybrid interest products, and, very importantly, guidance on how to record interest-bearing demand deposits on quarterly bank reports.”

ABA and others have pointed out to the Federal Reserve and FDIC that there are many technical issues involved and have asked for more time for banks. There has been no indication that this will be forthcoming.

Deposit insurance angle

Adding some uncertainty is deposit insurance, in the mid-term. Until the end of 2012, businesses have unlimited insurance on noninterest-bearing demand deposits. Under Dodd-Frank, if they opt for interest-bearing accounts, they only receive the now-standard $250,000 coverage.

But in the short term, some bankers have more certainty. For example, Charles Brown, chairman and CEO at $148.6 million-assets Insignia Bank, Fla., believes most large business account holders will tend to prefer full insurance, rather than receiving interest.

Other bankers agree. Iowa’s Guttau points out that in ordinary times, interest payments would be a priority for his customers. But in today’s economy, with so many uncertainties, he sees full insurance being a bigger draw.

Beneficial’s Gerard Cuddy, on the other hand, suspects otherwise.

“I think people will prefer to get the interest with the lower FDIC coverage,” he says, though there will be case-by-case differences.

Exceptions to “dis-interest”

While many banks would just as soon this issue be punted forward—maybe even permanently—there are some positives seen by some.

A key issue concerns sweep accounts. When market rates were much higher, “sweep” accounts were born. Broadly, the idea was that the deposits in sterile checking accounts were minimized by sweeping excess funds out of them and into interest-bearing arrangements. A very common arrangement was sweeping funds into repurchase agreements, or “repos” for short. Essentially, a bank sold securities from its portfolio to the business depositor, temporarily. The investment instrument secured the arrangement and the depositor received interest for the short-term investment.

Business customer interest in such arrangements has varied, and in many of the banks interviewed, customers with larger balances tended to use them. In some institutions the process was automated, in others a cumbersome manual routine had to be followed.

Now, for those banks that have had customers in sweeps, life will be simpler, eventually. They will be able to deliver interest without sweeps, and their investment portfolios, the source of the “repos,” will no longer be encumbered. Darling knows of one large community bank where 50% conversion out of sweeps would free up $300 million in securities.

Some banks have seen less customer interest in sweep programs in the low-rate environment of recent times.

But for those who still have substantial participation in sweeps, a side benefit of the shift will be the return of the deposits to the bank, and greater simplicity. Though many institutions sit flush with cash right now, that won’t necessarily continue to be the case.

Potential competitive impact?

Consultant George Darling is skeptical about anyone who hopes only to get deposits, pointing out that credit is what many firms want, and they’ll change banks to get loans and move their deposits at their new lender’s request.

“I don’t think a lot of companies are going to move their relationships just to get interest on demand deposit accounts,” says Darling.

There’s common agreement among bankers interviewed that a big reason they are relatively calm about this aspect of Dodd-Frank is the low-rate environment. When the return on an account is measured in basis points, rather than percentage points, it’s not exactly the stuff that quickens your pulse.

But those who take a longer view think more will be going on.

“It will be a new paradigm,” says analyst Dan Geller. “It is hard to gauge how it will evolve. Definitely, competition will intensify.”

There is also a minority viewpoint, in specialized situations. Not as strong as Beneficial, but not to be ignored.

Some community savings banks, only recently entering the business banking arena, see the change as an opportunity—a chance to attract new customers for all services with interest on checking as an introduction.

In Vermont, for instance, Dan Yates, president and CEO of $185.7 million-assets Brattleboro Savings and Loan Association, notes that the thrift is the only banking institution that is still headquartered in its part of the state. This is driving a decision to expand activities.

Interest on business checking “is a great opportunity for us,” done carefully, says Yates.

“One school of thought is, if you are going to do it, this is the time, with interest rates where they are,” says Yates. However, he adds, “there is the question, what do we do when rates rise?”

At present, even though the bank has plenty of deposits, Yates notes that a shift to business checking could be a boon for the traditionally consumer-focused company. Even if Brattleboro were to pay 20 basis points on business checking, he points out, its average cost of funds currently is 199 basis points—nearly ten times the cost of the business deposits.

“That doesn’t sound bad,” says Yates. “But again, that’s today.” The future rate policies of the Federal Reserve remain an unknown.

Pricing interest-bearing accounts

Market Rates Insight’s Geller, who studies pricing trends, notes that there is no historical data to go on. With interest on business checking being banned in the 1930s—indeed, until the nationwide advent of NOW account in the 1980s, interest on any transaction account from a bank was barred—“we’re looking at 80 years when no interest was paid on business checking,” says Geller.

What evolved instead was the “earnings credit,” a form of quasi-interest that was computed to give customers a return for interest-free use of their funds.

Those banks that used this approach, in a process generically referred to as “analysis,” offset the quasi-interest against the various fees charged for processing items, etc. Larger banks tended to have more sophisticated analysis programs, but a significant number of community banks use some form of the practice.

“Congress seems to think there’s a free ride, a free lunch, here,” says N.J.’s Frank Sorrentino. “But you can’t keep chopping away at banks’ profitability. ” In reaction, as community banks address it, there will be a rethinking and repricing of business checking services.

Connecticut’s Rheo Brouillard says his bank will give business depositors a choice, most likely: earnings credits or explicit interest, but not both. Customers will be asked to decide which way they want to be paid.

“Mind you, if they get interest, they are going to pay service charges,” says Brouillard. He says his bank would aim to make the transition as neutral as possible.

Community bankers suggest that business customers tempted by a large bank’s attempt to win them away may want to look closely at the overall pricing before they leap.

Says Robert Chapman, president and CEO at $862.2 million-assets United Bancorp, Tecumseh, Mich.: “Whatever they see, they’ll need to peel the onion back to see what’s really transpiring.”

For some, more technical implementation may be in the cards. Consultant Mike Moebs notes, for instance, that a little over 60% of all depositories offer a business checking account, but that only one in five uses formal account analysis. Moebs suspects that both the advent of explicit interest, and the need for using a sharp pencil in a poor economy, will have small businesses looking everywhere for what they can find. A bank that doesn’t give complete data concerning usage of accounts by a customer may find itself at a disadvantage, says Moebs.

In any event, Moebs thinks community bankers ought to be more enthusiastic about interest on checking. There are advantages for smaller banks in reserving requirements, he points out, that will give them an edge.

“If I were a community banker, I’d be licking my chops and getting ready to unleash the bank business checking account,” says Moebs.

But consultant Greg Judge doesn’t see the experienced business institutions making too big a deal of this, leading their markets to grab up accounts.

“I can’t imagine a good business bank doing that,” says Judge.

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