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Statement of the Shadow Financial Regulatory Committee

on

Sweep Accounts and the Prohibition on Paying Interest on Reserve Balances and Demand Deposits

December 7, 1997

In its planning document prepared for the Government Performance and Results Act, the Federal Reserve Board notes that the use by banks of sweep accounts may complicate its implementation of monetary policy. The Committee finds no justification for this conclusion. Furthermore, it does believe that sweep accounts present a potential risk to the FDIC's insurance funds. To the extent that these accounts sweep demand deposits into overnight repurchase agreements, they strip the banks of their highest quality assets, e.g., Treasury securities. This is not in the best interest of the FDIC or the taxpayer.

Moreover, the Federal Reserve argues that the incentive for banks to offer sweep accounts would be reduced if Congress authorized the payment of interest on reserve balances. Although payment of interest on reserve balances is desirable, the Fed's reasoning is incorrect. The incentive of banks to offer their customers interest yielding sweep accounts comes from the prohibition of interest payments on demand deposits, not on bank reserves. Sweep accounts are an inefficient way of paying interest on business demand deposits. The prohibition of interest payments on demand deposits is a remnant of the Banking Act of 1933 that has long outlived any supposed usefulness, and should be repealed. Paying interest directly on demand deposits is both more efficient and safer for the banking system than encouraging bank use of sweep accounts.