

# Strategies for Dealing with the Repeal of Regulation Q

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## Strategies for Dealing with the Repeal of Regulation Q

Effective July 21, 2011, 75-year-old Regulation Q will come to an end as the new guidance from the “Dodd-Frank Wall Street Reform and Consumer Protection Act” takes effect. As bankers plan their response to this significant challenge, there appears to be a small silver lining for the financial institutions that are willing to make bold moves in changing their products and services.

Many bankers are in no hurry to change low-cost funding for an interest-bearing account that will create another competitive thorn in their side. One more account that will require them to keep shopping the area banks to make sure their rates are competitive.

Certainly interest expense will rise, but no one is sure how much or when. Like many other products and services, this change can be met with a “defensive” or “offensive” approach.

Most bankers want to avoid the “bleeding edge” of introducing new products and services early in the availability cycle because they may not meet the expectations of the market, which is subject to change as more banks step forward. However, taking the “head-in-the-sand” approach may also be disastrous. Now is the time to convene the planning meetings, make the research calls to other bankers and start fleshing out a long-term strategy.

Being part of the “second wave” eliminates the opportunity to gain “pioneer publicity” with new products and an “aggressive” launch, but it mitigates the risk of looking amateurish if you are missing a key feature.

Strategies to Consider:

- Wait and see what the industry does and develop your plans accordingly.
- Immediately introduce DDA interest bearing accounts for Commercial Customers.
- Develop your plan, discuss it in a focus group with three of your high-balance customers, make the necessary adjustments and be ready to implement when the time is right.

### Relevant Facts

The first step in developing a viable strategy is to research and document as many facts as possible because commercial customers pose an immeasurable number of variables that cannot be determined in advance.

#### Facts or Highly Probable Situations

1. Monies paid as interest may be subject to taxes.
2. The Earnings Credit for Account Analysis and most investments is low and is not expected to increase significantly in the near-term.
3. The bank has a large number of commercial customers.
4. Most commercial customers will want compensation for their funds long-term.
5. Most commercial customers with investable funds have an account(s) with an investment firm.
6. The relationship with many commercial customers will allow the bank to discuss the opportunities for moving funds from an investment firm back into the bank.
7. The bank has a strong technology infrastructure and can handle a bold strategy.
8. The bank needs more deposits.
9. Cash Management products and services can generate more fee income than it currently does.
10. The word “free” is frowned upon in consumer advertisements by federal regulators and will most likely come under attack for commercial customers at some point.

## Strategy #1 Effective Delivery and Communications

### Internet and eDocuments

In the eDocuments Chapter of the “Cash Management for Community Banks Toolkit,”<sup>©</sup> we discuss analysis and implementation of the Internet delivery channel. This channel can be secured for delivery of many computer generated documents at a fraction of the cost for a paper equivalent. For example, the delivery cost for a paper statement is about \$2.69 versus \$.10 for an electronic version. Similarly, computer-generated notices cost about \$.97 each to process and mail versus \$.10 for an electronic version.

**Paper Statements and Notices are Expensive**

★chron.com  
Houston Chronicle  
October 20, 2010

“Paper and print costs around \$2.25 (per statement). Add postage to that (\$.44 ), and if banks are losing income from other avenues, someone has to pay for that.”

Brian Riley, Tower Group

\$2.25 Labor & Supplies  
.44 Postage\*  
\$2.69 per Statement

\* Average for permit rate and "over 1 ounce"

In fact, you should consider charging extra for paper statements and notices. Commercial customers are used to products and services that provide benefits and lower cost and they are much easier to sell than a consumer. According to the ABA, most consumers do not use their statements, but commercial customer do and will quickly understand the benefit in being able to receive it the same day it is generated. As you will see in the Marketing Chapter of the Toolkit, E-Mail and electronic newsletters are popular among customers and a proven way to strengthen customer retention and market new products or changes in the existing product line.

### Free to Fee Checking

Now is the time to start phasing out “Free” products and services. Although the regulators have not expressly prohibited using Free Overdraft programs for commercial accounts, it is only a matter of time. If it made sense for regulators to restrict usage of Free overdraft protection for consumers, the same logic will creep into the guidance for commercial customers. If you have to pay interest on an account – it certainly makes sense to stop giving them away.

## Strategy #2 Discontinue Free Business Checking

### Notice to Free Business Customer of Account Change

#### Small Business Checking Account \$8.95 per month

Business customers should be notified that the bank is discontinuing Free Business Checking Account on the effective date and unless the customer contacts the bank and directs them otherwise, the customer’s Free Business Checking Account(s) will be moved to “Small Business Checking Account” or “eGreen Business Checking,” depending on whether the account is linked to Online Banking and eDocuments.

(Restrictions Vary – See Account Description Table Below).

## Strategy #3 Soft Elimination of Free Checking

### eGreen Business Checking

A subset of your commercial customers want the cheapest account possible. There is no cost for the eGreen Business Account, but the customer does have to setup Online Banking and receive statements and notices electronically. However, this once-in-a-lifetime repeal of Regulation Q will give your bank the opportunity to revise the standards and require Online Banking and eDocuments to avoid a service charge. Additionally, it does not pay interest. This account will satisfy many low-balance customers that want free checking and it drives down the cost to service them.

## Strategy #4 Interest Bearing Account

### eGreen Business Checking Gold

This is what the clamor is about, an interest-bearing commercial account. Given the available investment rates, it is hard to imagine that a large number of commercial customers will line up for the new feature. However, this account could include: Account Analysis, interest, service charge, Online Banking and eDocuments. The service charge should probably be in the \$7.95 to \$8.95 range, with the feature of avoiding the service charge with \$1,000.00 Minimum Balance or \$3,000.00 Average Collected Balance.

## Strategy #5 Cash Management Account

### eGreen Cash Management

For larger commercial customers that need or want Cash Management, this account uses Account Analysis to analyze the qualifying account(s), determine the aggregate service charge and calculate the value of their funds based on the earnings credit rate set by the bank. If the customer's earning credit is insufficient to cover the service charge, a debit is created and hard-charged to his account. If there are excess funds, a credit is created and deposited into his account. The important components in this strategy is the bank will only pay out the difference between the Earnings Credit and the Service Charge and it is focused on Cash Management.

As footnoted in the Account Description Table, this account will be underpinned by a bundle of Cash Management Products and Services. Banks have considerable flexibility in pricing bundles and can easily develop the set that works best for a given marketing area.

For example, a customer with offices in five cities may have a corresponding number of banks that are local to their offices. Using Cash Management Remote Deposit Capture or ACH and Cash Concentration, the customer may be able to eliminate several bank relationships, which would result in significant savings and higher balances in your bank.

Account Description Table

Product or Service	Account	Monthly Service Charge	Minimum Balance to Avoid Service Charge	Average Balance to Avoid Service Charge
Free Business Checking	Discontinued	N/A	N/A	N/A
Small Business Checking	Non-Interest Bearing	\$8.95 <sup>1</sup>	N/A	N/A
eGreen Business Checking	Non-Interest Bearing	No Service Charge <sup>2</sup>	N/A	N/A
eGreen Business Checking Gold <sup>1</sup>	Interest Bearing <sup>3</sup>	\$8.95	\$1,000.00	\$3,000.00
eGreen Cash Management <sup>1,4</sup>	Interest Bearing <sup>2</sup>	Bundled Cash Management Fees	Account Analysis <sup>5</sup> and Published Interest Rate	Account Analysis <sup>5</sup> and Published Interest Rate

<sup>1</sup> Does not require eDocuments or Online Banking

<sup>2</sup> Must have Online Banking and eDocuments

<sup>3</sup> Rate is usually tied to 90-Day T-Bill Rate

<sup>4</sup> Customers offered "bundle price" for Cash Management Products and Services

<sup>5</sup> Account Analysis used to determine fee base and hard-charged debited or credited for the difference

# Account Analysis

## Narrative

Account Analysis is a service that allows a commercial customer to avoid service charges by maintaining compensating balances. Instead of their account being "hard charged" and debited for services used throughout the month, a running total, or "soft charge" is kept. At the end of the month, the customer receives an earnings credit on the average available balance in the account.

- If the earnings credit is greater than the soft charge total, the service charge, or part of it, is not deducted that month.
- If the amount of the earnings credit is less than the soft charge, the fees that exceed the earnings credit will be charged.

Many customers strive to maintain the minimum balances to offset the monthly service charge, which they generally consider superfluous. Account Analysis is widely used because it provided a loophole in federal Regulation Q, which prohibited banks from paying interest on most commercial checking accounts. Regulation Q is repealed on July 21, 2011 and banks will be allowed to pay interest on commercial accounts.

## Compensation is Expected

Although Account Analysis cannot generate income for a banking institution, it can build customer loyalty by acknowledging that some of your business customers maintain high balances in their checking accounts. In an era of financial sophistication, Chief Financial Officers (CFO) are trained to maximize cash flow and avoiding services charges is a basic practice.

Many banks have avoided implementing Account Analysis because they do not want to negatively impact earnings by allowing customers to avoid paying service charges. This presents a high customer retention risk when those customers become sales prospects for competitive banks that do offer the service. Also, it is not uncommon for a loan officer that leaves one bank for a competitor to target specific high balance customers that he or she knows are not being compensated for their balances.

## What Should Be Included in Account Analysis?

What to include in Account Analysis is a question that is as old as the service itself. For example, most banks today are planning to provide Remote Deposit Capture, which includes having either the bank or customer purchase a check scanner. Scanners can easily cost \$650 each for a small to medium-size customer. Then comes the internal quandary – should the scanner be included in Account Analysis? The salespeople emphatically say “yes” and the CFO says “absolutely no way.” It is a scene that is played out in banks every day. If you add 300 customers, you have created \$195,000 in expense that will, in the best case, allow the service to break even financially. Of course, this does not factor in the high value of using the service to attract new deposits.

“But,” says the salespeople, “that is exactly what Account Analysis is intended to do – compensate the customers for their balances.”

Some banks have a taken middle-of-the-road approach and included the system/software cost, but not the scanner. The explanation to the customer may sound like, “It is similar to PCs, which we do not include in Account Analysis.”

Unfortunately, there is no formula or accounting rule that supports either side of the argument, but you can be assured that the issue will come up.

## Great Depression Created Need for Regulation Q

The stock market crash in October 1929 brought to end an era of unprecedented growth in America’s history and ushered in the Great Depression. The depression took a devastating toll on America; homes and farms

were lost and thousands of factories were idled. At the depth of the depression, twenty-five percent of the workforce was unemployed.<sup>6</sup>

For most of the decade after the depression began, congress was intensely focused on restoring the country's economic health. Pressure was unrelenting on government and the private sector to invest in building new plants, upgrading equipment and getting America's workers back on the job. It was clear that congress was more concerned about growth than savings and it was manifested in a series of new laws.

To prevent funds from sitting idle in checking accounts to generate interest, Regulation Q was enacted, which prohibited banks from paying interest on most business checking accounts.

### **Unintended Impact of Reg. Q**

As the depression was waning, deregulation and globalization had taken root and the result for the banking system was a significant outflow of funds to Europe where interest rates were not limited by Regulation Q.

By keeping funds in countries where they were working during war reconstruction, companies had immediate access to their operating funds and received interest on funds when they were idle. To many companies, it seemed responsible to their stockholders to move more funds from the U.S. to Europe because they were compensated for their funds by a market-driven interest rate.

### **Another Approach – but Restricted**

Another approach to dealing with the restrictions of Reg. Q was the introduction of Negotiable Order of Withdrawal – or (NOW) Accounts.

NOW accounts are restrictive interest-bearing transaction accounts that combine the payable on demand feature of checks and investment feature of savings accounts. NOW accounts began in Massachusetts in 1974 when mutual savings banks offered interest bearing transaction accounts to compete with commercial banks.

These accounts allowed a bank to pay interest on deposits in transaction accounts, but restricted the number of transactions to six per month. For the average commercial customer, limiting the number of allowable transactions made the approach too restrictive and the growth was understandably limited.

### **Investment Sweep Accounts**

The emergence of money market funds, which pooled cash to invest in money market instruments, caused further erosion of bank deposits. Fidelity, AIM and Dreyfus are just a few investment companies that manage large commercial portfolios – and were created as the result of banks not being able to pay interest on commercial funds.

Threatened by deposit run-off to investment houses by commercial customers that demanded to be compensated for their balances, banks quickly moved from simple checking accounts and services to more complex products, such as Investment Sweeps. This new service had the appeal of being able to invest the funds “on-balance sheet” as a repurchase agreement – or “off-balance sheet” through money market mutual funds services. Either way, it gave the banker an effective tool for combating deposit runoff. However, with “off-balance sheet investments,” banks continued to drive funds out of the banking system.

### **Account Analysis Created**

The success of investment companies to draw idle checking account funds from banks was unprecedented. Even the Fed was impacted by the transition. “In 1993, the Federal Reserve Bank maintained approximately \$28 billion in reserves and today only about \$6 billion is left.”<sup>7</sup>

In response to the runoff in checking balances, Account Analysis was created to compensate companies for their balances. Although many bankers argue that Account Analysis is not enough – it does give bankers a service that is simple to administer and is now easily understood by customers.

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<sup>6</sup> Library of Congress, “Great Depression and World War II, 1929-1945”

<sup>7</sup> Daniel D. Gill, CCM, The Weiland Financial Group

The early systems created analysis statements that used confusing language that was difficult to understand, but they seemed to placate grumbling customers. Terms like “Monthly Maintenance” could mean anything the bank wanted. Bankers were understandably concerned that a monthly statement would make it too easy to compare their costs with a competitor.

In 1987, the Treasury Management Association (TMA) recognized the need for standardization and developed the “Account Analysis Standard.” This was the first of many steps toward standardizing and simplifying the analysis process and statement. They developed standardized terminology and definitions for bank products and services. The codes were updated in 1993, to include 1,300 products and services.

## The Components of Account Analysis

It is important to understand the various parts of the Account Analysis, not only from the banking standpoint, but in order to effectively explain them to business customers. The following terms are commonly used in Account Analysis:

- **Charging Options:** Primary Account set with charge code to charge the loss, charge the charge or calculate but not charge.
- **Qualifying Transactions:** Core systems vary significantly as to which products, services and transactions are automatically input into Account Analysis. For example, some system do not automatically count and charge the checks deposited through Remote Deposit Capture, which requires manual input if they are to be used.
- **Activity Report:** Provides a description of all account activity, the cost for each activity and the collected balance required to offset each type of activity, without having to pay a service charge.
- **Balance Summary:** The sum of the daily collected balances in the account divided by the number of days in the month. Its purpose is to provide a balanced picture of the account based on a monthly average, rather than peak and valley activities.
- **Reserve Requirements:** A percentage determined by federal regulation that the bank is required to have available for immediate use and that cannot be used for investments.
- **Earnings Credit Rate:** Usually based on the Federal Reserve Bank’s Discount Rate, it is applied to the Average Collected Balance to calculate the earnings value of investable balance on an account. The Earnings Credit Rate is established by the bank, but is normally based on the 90-day T-bill rate.
- **Net Activity Charges:** If the amount of the Earnings Credit is greater than the soft charge total, no fee is deducted from the customer’s account. If the amount of the Earnings Credit is less than the soft charge total, the remaining fees are deducted from the account as a service charge.
- **Average Daily Collected Balance:** The balance in which the bank has received settlement; ledger balance minus float. The average collected balance is the sum of all collected balances for the month divided by the number of days in the month.

The typical calculation of Account Analysis follows:

1. The value of balances is determined:
  - + Average Monthly Collected Balance
  - Reserve Requirement
  - = Investable Balance
2. The Earnings Credit is calculated:
  - + Investable Balance
  - x Earnings Credit Rate (ECR<sup>8</sup>)
  - / Divide by 365 (ECR is annual rate)
  - = Daily Earnings Credit

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<sup>8</sup> Rate is usually tied to 90-Day T-Bill Rate

3. The Monthly Credit is Calculated:
  - + Daily Earnings Credit
  - x Number Days in Month
  - = Monthly Earnings Credit
4. Determining the Charges for Services:
  - + Monthly Service Charge
  - + Per Item Charge
  - + Ancillary Charges
  - = Total Charges
5. Compare Earnings Credit<sup>9</sup> to Total Charges to determine actual service charge:
  - + Total Charges
  - Monthly Earnings Credit
  - = Service Charge

Obviously, this is a very simplified explanation of Account Analysis, but most banks have found that providing basic information keeps customers from getting bogged down in "analysis paralysis." In fact, many banks do not send the account analysis statement to the customer unless they specifically request it. What most banks have found is that customers want to know the account balances required to avoid a monthly service charge.

### **What Do I Tell Customers About Account Analysis?**

Many organizations have found that educating their business customers about account analysis is one of the best ways to build long-term customer relationships. When business customers realize that their bank is working with them to ensure they understand and use of all of the products and services that are beneficial in cash flow management and employee and operational efficiencies – it builds trust and strengthens customer retention.

For example, to help your business customers maximize their Earnings Credit, encourage them to be efficient in the number of bank relationships they maintain. If they use multiple banks consolidating them into your bank using Remote Deposit Capture or ACH will reduce the number of bank fees and increase their account balance at your bank, which will lower, or eliminate, their monthly service charge.

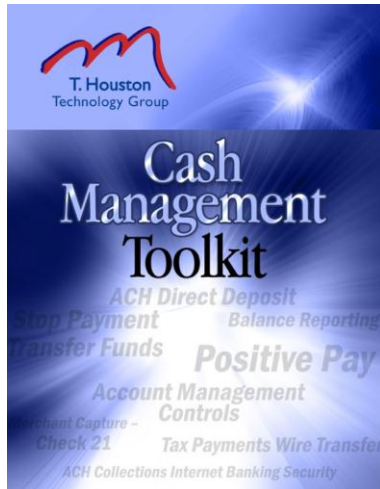
### **Account Analysis Statement**

Finally, it is important for your organization to determine whether to send business customers a detailed or summary-level account analysis statement. Some organizations find that sending a summary-level report avoids “analysis paralysis,” in which business customers become overwhelmed by trying to understand the details of account analysis. You can always generate an individual company’s detail statement, if needed, but as discussed – most companies are just trying to avoid paying the monthly service charge.

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<sup>9</sup> Typically, the earnings credit does not carryover to next month

## Cash Management Toolkit for Community Banks<sup>©</sup>



Tom Houston, President, T. Houston Technology Group, has published “**Cash Management–Toolkit<sup>©</sup>**,” an invaluable implementation manual for Cash Management.

Cash Management is a requirement to compete in today’s market. Businesses expect it and it is proven to generate significant revenue. This Guide makes implementing Products and Services fast and easy. Each chapter includes:

- Narrative
- Agreement
- Risk Assessment
- Policy
- Training
- Marketing
- Legal References

Houston said one of the main reasons for publishing the guide was “To provide a total package that lets any size financial institution provide Cash Management – and do it quickly and inexpensively.”

### Chapters include:

Introduction	E-Document Delivery
Pricing	E-Mail Marketing (Permission-Based)
Master Agreement	Investment Sweep
Account Analysis	Loan Sweep
Enhanced Account Analysis	Lockbox Processing
Account Reconciliation	Mobile Banking
ACH Origination	Online Banking
Alerts & Controls	Positive Pay
Bill Payment	Remote Deposit Capture
Bill Presentment	Social Media Marketing (Permission-Based)
Cash Concentration	Stop Payment
Cash Management	Wire Transfer
CD-DVD Archive	Zero Balance Accounting
Controls and Alerts	
Debit Cards	
Business	
Payroll (Reloadable)	

The Toolkit will save thousands on attorney fees and project time.

### Other Resources

- “Remote Deposit Capture Legal & Compliance”
- “Mobile Banking Toolkit”



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