AN OPPORTUNITY TO IMPROVE OUR FINANCIAL SYSTEM - UNIFORM RESERVE REQUIREMENTS

Remarks by

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This past April, the chairman of the Federal Reserve Board, Arthur Burns, called for legislation which would impose uniform reserve requirements on all financial institutions that offer demand deposits. This proposal is not new. Similar suggestions have been put forward before, in the reports of the recent Hunt Commission, the Heller Commission, and by the Commission on Money and Credit back in 1962. Moreover, the annual reports of the Federal Reserve Board for several years have also included this kind of recommendation.

But this time, the reaction to Chairman Burns' speech was swift and if I may say so, hostile, in contrast to the rather ho-hum reception it received in the past. Apparently the greater interest at the moment results from a belief that appropriate legislation is more likely now than at any time recently, partly because of the impending proposals to implement the Hunt Commission recommendations.

Some of the opposition to uniform reserve requirements is understandable, because such a law, if passed, would diminish the economic advantages enjoyed by certain financial institutions. One can appropriately describe current arrangements as similar to a discriminatory tax--paid by some and not by others in the same line of business. It is not surprising, therefore, that opposition has been voiced by those presently in a favored position.

Let me summarize the nature of the inequality that now exists. As you know, member banks of the Federal Reserve System are required to hold reserves in the form of vault cash or collected balances in Federal Reserve Banks equal to specified proportions of their deposit liabilities. These reserves, of course, earn no interest. In contrast, nonmember banks hold reserves in amounts and in the forms specified by the laws of the various states. In general, the state laws are less burdensome than the reserve requirements imposed on member banks--that is to say, in most states, member banks must hold a larger proportion of their assets in noninterest bearing form than similarly situated nonmember banks.

In many states, the percentage of deposits which must be held as reserves is smaller for nonmember banks than for the member banks. But even more important is the fact that in many states nonmember banks may hold reserves in the form of securities, correspondent bank balances, and uncollected checks. Since member banks will also need to hold liquid securities and correspondent balances <u>in addition</u> to the reserves they maintain with the Federal Reserve, it's not hard to see why frequently the earning power of a bank can be increased by withdrawal from the Federal Reserve System.

Reflecting the financial penalty attached to membership in the Federal Reserve System is the large number of withdrawals from membership in recent years. Chairman Burns pointed out that since 1960, about 700 banks have left the Federal Reserve System through withdrawals or mergers. Of 1,600 newly chartered state banks in that period, only 100 elected to join the Federal Reserve System. In 1966, 45 percent of the commercial banks in the United States were members of the Federal Reserve System. In May of this year, only 41 percent of the banks were members of the Federal Reserve System. During the same period, the proportion of the total commercial bank deposits in member banks declined from 83 percent to 78 percent. Over the past 10 years, 40 percent of the increase in checking account balances at commercial banks in the U.S. took place at nonmember banks.

To some degree the accelerating trend of withdrawals from the System may result from the upward trend of interest rates in recent years. When interest rates were low, the financial reward to a bank withdrawing from the Federal Reserve System was less than it would be today when interest rates are high. And let me assure you that with Federal funds yielding between 8 and 10 percent as they have in recent months, all banks, both member and nonmember, are very conscious of the contribution to earnings which can result from a policy of minimizing the amount of assets which do not earn interest.

It is understandable, therefore, that nonmember banks might be expected to resist the extension of Federal Reserve reserve requirements to them. And it's reasonable that they should inquire if the benefits to society which would result from uniform reserve requirements justify the financial penalty (or more accurately, loss of advantage) they feel they would incur. Obviously, Chairman Burns and the authors of the Hunt Commission report, the Heller Commission report and the report of the Commission of Money and Credit feel that the benefits to society would outweigh any disadvantages that might accrue to nonmember banks. So let's take a look at what benefits could be expected from uniform reserve requirements.

As you know, the academic community, the financial community and the Federal Reserve in recent years have all attached more significance to the behavior of the money supply and the so-called "monetary aggregates" than was true in previous years, when interest rates and free reserves were given a great deal more attention. I think it is fair to say that today most students of money and banking agree that the effectiveness of monetary policy depends to a considerable extent on how well the Federal Reserve can regulate these aggregates.

It's no secret that the monetary growth rate actually achieved has frequently departed from the rate that we in the Federal Reserve have intended. At times the departures have been sizeable. One reason, though admittedly not the most important, for this lack of precision is the fact that a growing proportion of the money supply and the other monetary aggregates is accounted for by nonmember banks whose liabilities constitute part of the money supply but whose reserves cannot be directly controlled by the Federal Reserve System.

Let me underline that I am not suggesting that the effectiveness of monetary policy is greatly undermined at present by the lack of uniformity in reserve requirements. But the problem is getting more serious, and there is room even now for improving the effectiveness of monetary policy by asking all banks to observe the same reserve requirements. And certainly, equity among similarly situated and competing financial institutions would be served by such a change. Why then, the strong reaction against this proposal?

Last month, Larry Kreider, executive vice president and economist for the Conference of State Bank Supervisors, described the uniform reserve proposal as a "frontal attack" on the basic freedoms of the entire banking industry.

He said that "there is no convincing evidence that compulsory affiliation (with the Federal Reserve) would lead to more effective monetary policy. Certainly freedom from compulsory affiliation cannot be blamed for the poor batting average (of the Fed) from 1965 to date..." To this I would reply that we do not claim uniform reserve requirements will save us from inappropriate monetary policy. What we do claim is that when monetary policy is appropriate, and we hope that it will be most of the time, then uniform reserves will help us to be more effective and more precise.

Another point that Kreider argues is that "compulsory affiliations for reserve purposes cannot be expected to yield greater equality among the banks. The data is clear. Banks over which the Fed has reserve-setting powers have greater inequality among them--as measured by noninterest bearing assets as a ratio to total deposits--than exists between member and nonmember banks of a comparable size grouping." There are three things that I would like to say about this:

1) We recognize that reserve requirements for members are graduated by size of deposits, and this can be described as "inequality". But size graduation can also be thought of as more reasonable and "less inequal" than the reserve city/country bank classification system that was in effect prior to this year.

2) The ratio of interest bearing assets to total deposits is not the best measure of the relative burden of reserve requirements between member banks and nonmember banks. As Dr. Burns pointed out, "For nonmember banks, required reserves are, in effect, earning assets even when they are held in demand balances with other commercial banks, since these balances normally also serve as a form of payment for services rendered by city correspondent banks." 3) Withdrawals from membership in the Federal Reserve System reflect the generally lower burden of reserve requirements for nonmember banks and not differences in reserve requirements among member banks.

Spokesmen for the Conference of State Bank Supervisors frequently express the view that compulsory membership in the Fed, or even uniform reserve requirements for all banks, would constitute a threat to the survival of the dual-banking system. This, I submit, is a myth.

If I understand the term properly, the dual-banking system refers to the dual-sources of the bank charters in America--the state governments on the one hand or the federal government on the other. Membership in the Federal Reserve System in no way restricts the freedom of a bank to operate under a state charter. As I am sure you know, we have a considerable number of state chartered member banks even though, as I remarked earlier, the financial attraction of nonmembership has worked to curtail the number of state chartered member banks. National banks, of course, are obliged by law to be members of the Federal Reserve System.

Concerning the dual-banking system, the Hunt Commission report states that "The Commission believes that the widest feasible options among chartering and supervisory agencies should be created and maintained. When a particular type of financial institution can be chartered by only one agency--whether state or federal-- a two fold danger emerges. First, the agency may become over-zealous in protecting existing firms, with the result that entry by new firms is effectively foreclosed. Second, the agency may not be as innovative and imaginative as it should be in exercising its authority. Opportunities for dual-chartering and supervision mitigate these dangers and improve service to the public." In addition to preservation of the dual system, the Commission also asks for mandatory membership in the Fed. Mr. Burns has not asked that.

I would not quarrel with the findings of the Hunt Commission. I would stress that it is misrepresentation to say that uniform reserve requirements or even mandatory membership constitute a threat to the dual system. The only curtailment of the power of the states which uniform reserves would entail would be the elimination of their power to set reserve requirements.

It is important to understand that uniform reserve requirements alone would not alter the supervisory relationships which now exist. Nonmember banks are now supervised by the Federal Deposit Insurance Corporation in addition to the supervision afforded by the various states. This would not change.

On a different line of attack, it has been suggested that uniform reserves would somehow involve a great deal of Federal Reserve intervention in the management of banks. For example, Dr. Kreider said, "First, in operating our banks, we want to have the flexibility needed to serve our trade area. Generally, if we want to make a sound loan and have lendable funds to do so, we should not have to get the approval of anyone outside the bank or bank board. If we need to ask our correspondent bank for participation on a loan, we should be free to do so--again within the limitations of lendable funds available to both parties. We should be free to determine within a competitive environment where we go for our participation loans. To have someone from the government, whether state or federal, tell us we should not make a specific type of loan at a certain point in time, should not compete to increase loans consistent with total funds made available to the economy through the Fed's Open Market Committee, should increase certain types of loans as determined by a governmental employee some distance from our trade area, or where we should go for any correspondent type of service, violates what most of us believe to be basic freedoms.

For a bureaucat, irrespective of the trappings of his position, to tell a banker how and for what he should allocate funds assumes that he knows the banker's milieu better than the banker, that he is more honest than the banker, and that he has a greater interest in the particular trade area than does the banker, his board, stockholders and customers. These are assumptions that most of us would reject out of hand." It is understandable that bankers would be alarmed at the prospect of this kind of supervision. The facts are, however, that the uniform reserve proposal does not contemplate any change in the supervisory relationship which now exists. Nonmember banks would remain under the jurisdiction of the Federal Deposit Insurance Corporation and the state banking authority.

Another charge which Dr. Kreider and other critics of the uniform reserve proposal have made is that correspondent bank relationships would be greatly altered. He states, "You see, greater Fed control...would dilute the vitality of correspondent services which are provided primarily by member banks, correspondent services, along with correspondent balances, would gradually be translocated from the private, competitive sector of the economy to a highly centralized government agency. I don't think that this would contribute to the type of democratic economy most people want."

I don't deny that uniform reserve requirements might alter existing correspondent bank relationships. One reason for this would be that with uniform reserve requirements the incentive to be a member bank would be greater because of the services the Federal Reserve provides to member banks. Nonmember banks are not entitled to some of these services. The nonmembers must rely upon their correspondent banks to obtain the same services. Thus, it is likely that uniform reserves might cause more banks to seek membership in the Federal Reserve System and to utilize the services provided by the System.

However, there are a number of services provided by the correspondent banks which the Federal Reserve is unable to provide. On example would be overlines. If a bank receives a loan application which exceeds its legal lending limit, the Federal Reserve cannot share in that loan as a correspondent bank can. Investment advice would be another area where the Fed is unable to provide service. Bank stock loans are another area. Some of the correspondent banks furnish consulting services on all phases of commercial bank operations. The Federal Reserve does not supply this kind of service. What I'm trying to say is that the need for correspondent banks would not disappear if all banks were required to observe uniform reserve requirements.

Finally, a distressing feature of Dr. Kreider's recent remarks was his reference to Chairman Burns' request that large nonmember banks observe the new "marginal" reserve requirements on certificates, requirements that have already been imposed on member banks. He said "by no stretch of the imagination could that request of the Fed be expected to be of any value to monetary policy, even if every single bank were to comply with the request, which fortunately they will not." (Emphasis added) One can legitimately debate the value of the marginal reserve request in curbing excessive bank credit growth, but it's certainly unfortunate to have an official of one regulatory group encourage publicly noncompliance with a policy-based request by another.

In closing, I'd like to return to the oft repeated allegation made by officials of the Conference of State Bank Supervisors, namely that uniform reserve requirements are a "frontal attack" on the dual banking system. The only logical interpretation I can put on this kind of emotional appeal is that the supervisors believe that the only reason banks apply for and retain state charters is because of the competitive advantage that less onerous state reserve requirements provide. My own belief, as I said earlier, is that the dual banking system has a legitimate basis. Getting by on the cheap is not it. I'm doubly pleased to note that state chartered banks in Montana have in such large numbers seen fit to be members of the Federal Reserve System. I don't think those banks should be required in effect to pay a tax for such membership.