

THE FED AND THE DUAL-BANKING SYSTEM

Remarks by

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President
Federal Reserve Bank of Minneapolis**

at the

**Northern Regional Convention
Bank Administration Institute**

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A year ago, the chairman of the Federal Reserve Board, Arthur Burns, called for legislation which would impose uniform reserve requirements on demand deposits at all financial institutions. That legislation has now been drafted, and was submitted to Congress with the Administration's endorsement last January.

The reaction to Chairman Burns' proposal was swift, hostile, and in my opinion not very well reasoned. Of course, some of the opposition to uniform reserve requirements is understandable, because such a law, if passed, would diminish the economic advantages now enjoyed by non-member banks. In effect, the current reserve discrepancies are like a discriminatory tax -- paid by some and not by others in the same line of business.

Let me summarize the nature of the inequality that now exists. As you know, banks that are members 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 earn no interest. In contrast, in a number of states, the percentage of deposits that must be held as reserves is smaller for non-member banks than for members. But more important, in many states non-member banks may hold reserves in the form of securities that earn interest, correspondent bank balances that can claim services, and even uncollected checks. Since member banks also need liquid securities and correspondent balances in addition to the reserves they maintain with the Federal Reserve, it's not hard to see why bank earnings can frequently be increased by withdrawal from the Federal Reserve System.

Reflecting this financial penalty attached to membership is the large number of withdrawals from membership in recent years. Since 1960, about 700 banks have left the Federal Reserve System. Of 1,600 newly chartered state banks in that period, only 100 elected to join. During roughly the same period, the proportion of deposits in member banks declined from 83 percent to 78 percent of the total. And over the past ten years, 40 percent of the increase in checking account balances at commercial banks took place at non-member banks.

To some degree the accelerating 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 that withdrew from the Federal Reserve was less than it is today when interest rates are high. With Federal funds yielding 11 percent, all banks, both member and non-member, are obviously anxious to minimize the amount of assets that do not earn interest.

It is understandable, therefore, that non-member banks resist the extension of the Fed's reserve requirements to them. And it's reasonable that they should inquire whether the benefits said to result from uniform reserve requirements justify the financial penalty (or more accurately, loss of advantage) they feel they would incur. So I'd like to 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 than was true previously, when interest rates were given a great deal more attention. In fact, 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 control the growth of deposits.

Now it's no secret that money growth has frequently strayed from the rate that we in the Federal Reserve have intended. At times the departures have been sizable. One reason for this lack of precision is the fact that a growing proportion of the money supply is accounted for by non-member bank deposits, deposits over which the Fed has much looser control. For example, \$1.00 of reserves at the Fed on average supports about \$7.00 of demand deposits at member banks, but as much as \$50.00 of such deposits at non-member banks. Obviously, it's difficult to tell how much money we're creating with this kind of range of variation.

Moreover, under present circumstances, with inequitable impact on different banks, we are very reluctant to use changes -- and particularly increases -- in reserve requirements as a means of implementing monetary policy. Thus, one tool that could be of help at times is largely immobilized.

Let me underline that the lack of uniformity in reserve requirements is only one of the factors causing difficulties for credit policy. But the problem is getting more serious. Why, then, the strong reaction against this proposal?

Larry Kreider, executive vice president and economist for the Conference of State Bank Supervisors, has 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.

Kreider also argues that "compulsory affiliations for reserve purposes cannot be expected to yield greater equality among banks ... Banks over which the Fed has reserve-setting powers have greater inequality among them ... than exists between member and non-member 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, with smaller banks required to maintain lower ratios. This can be described as "inequality", of course, but more realistically discrimination by size in a rough way only offsets some of the advantages of large-size banks, and thus is economically, as well as politically, justifiable. In any case, it's not the same as having unequal rules for otherwise equal competitors. 2) The degree of inequality between members and non-members is greater than the crude figures indicate, because non-members in fact get substantially more services for their correspondent balances than the Fed can offer against reserves. 3) Withdrawals from membership in the Federal Reserve System, clearly reflect the inequality between members and non-members, not differences in reserve requirements among member banks.

It has also been suggested, erroneously in my view, that uniform reserves would somehow involve a great deal more 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 ... 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 ... 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 bureaucrat, 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."

If any of this malarky were true, then bankers should be alarmed. So would I be. But this sort of argument is strictly a red herring: the uniform reserves proposal does absolutely nothing to change the supervisory relationships that now exist, and thus in no way invites more or different public intervention in the private sector.

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, simply because the proposal, if enacted, would remove an important disincentive to Fed membership. But there are a number of services provided by correspondent banks that the Federal Reserve has no intention of providing. One 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 not prepared to provide service. Bank stock loans are another. Some correspondent banks furnish consulting services on all phases of commercial bank operations. The Federal Reserve does not supply this kind of service. Thus the need for correspondent banks would not disappear if banks were required to observe uniform reserve requirements.

Finally, spokesmen for the Conference of State Bank Supervisors frequently express the view that compulsory membership in the Fed -- which we are not talking about -- or even uniform reserve requirements for all banks, constitutes a threat to the very survival of the dual-banking system. This also, I submit, is pure myth.

If I understand the term properly, the dual-banking system refers to the dual-sources of bank charters in the United States -- the state

governments on the one hand, or the federal government on the other. Uniform reserve requirements would in no way restrict the freedom of a bank to operate under a state charter, and thus choose among different supervisory and examining authorities.

Concerning the dual-banking system, the Hunt Commission said: "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."

I personally support these arguments for dual banking. But it is misrepresentation to say that uniform reserve requirements or even mandatory membership constitute 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 unfair competitive advantage that less onerous state reserve requirements provide. My own belief is that the dual-banking system has a legitimate basis. Getting by on the cheap is not it.