April 10, 1961

To: Board of Governors Subject: Reserve city classification

From: John R. Farrell

Since the announcement on March 1, 1961, of the proposed amendments to Regulation D, Reserves of Member Banks, a number of protests have been received concerning various aspects of the proposed rules. Copies of the material submitted by the protesting banks have already been distributed to the Board.

The most serious protests received were from two banks in Hartford, three banks in Albany and the Albany Clearing House Association, three banks in Newark, and two banks in Phoenix arguing against the classification of these cities as reserve cities. These protests are commented on in the next section of this memorandum.

The protest received from one of the Newark banks (National State Bank) contains the following request:

> "No attempt has been made herein to present a formal brief but for the reasons set forth in this letter, we feel that Newark should not be classified as a Reserve City and we ask that the Board of Governors give us an opportunity to discuss the matter in more detail before the proposed amendments are adopted."

Protests have also been received from one bank in Charleston, South Carolina, three banks in San Francisco, and two in Los Angeles about the long-standing provision which includes deposits held by out-of-town branches among the deposits of the bank subject to reserve city requirements. These banks argue that it is inappropriate to subject out-of-town branch deposits to reserve city requirements because these branches are like country banks.

> The Legal Division feels that it is extremely doubtful that the Board has the power to prescribe differing reserve requirements for segments of a bank's demand deposits--e.g., 16-1/2 per cent against demand deposits held by the head office and 12 per cent against demand deposits held by out-of-town branches.

In addition, the Federal Reserve Bank of New York and the City National Bank and Trust Company of Columbus, Ohio, submitted suggested revisions of the paragraph in the proposed regulations concerning permission to carry reduced reserves.

> The New York Reserve Bank suggested that the phrase "the amount and frequency of its borrowings from its Federal Reserve Bank or other lenders" be eliminated from the list of factors which the Board may take into account in considering requests for permission to carry reduced reserves.

As the list in the proposed regulation is indicated as not being all-inclusive and since there is no objection by the Board's staff to the elimination of the phrase in question, it is suggested that the recommendation of the New York Bank be adopted.

The Columbus bank suggested[1/] that the paragraph in question be completely rewritten to provide in effect that any member bank located in a reserve city would have automatic permission to carry reduced reserves in any case where the daily average amount of total demand deposits of such a bank during the preceding calendar year was below a similar figure for any "country" bank in the same Federal Reserve district. This proposal would seem undesirable because its mandatory nature would ignore local competitive factors. The Board should have the flexibility necessary to consider each request for reduced reserves in the light of all the relevant factors pertaining to the particular case.

There is one other suggested change in the proposed revision of Regulation D which the Board may want to consider. It will be recalled that, at a recent Board meeting when Chairman Martin reported his conversation with Mr. Biggers of the Toledo Trust Company, there was some sentiment in favor of permitting banks in cities which were voluntarily retained as reserve cities under the "grandfather clause" to have their status reviewed more frequently than once every three years. In this connection the Legal Division has suggested that this purpose could be accomplished by inserting on page 6 of the March 1, 1961 mimeographed draft the following new paragraph (d):

(d) In any case in which the reserve city classification of any city is continued effective as of June 1, 1961, or as of June 1 of any third year thereafter, solely by reason of the provisions of subparagraph (5) of paragraph (a), the reserve city classification of such city may be terminated at any time after one year following the effective date of its continuance as a reserve city if a written request for such termination is

1/ The Columbus bank also proposed that member banks located in reserve cities in which there is no Federal Reserve Bank or branch be given permission to compute availability of credit for cash items from the time such items are dispatched by the member bank rather than from the time the items are received by a Federal Reserve Bank or branch. The bank feels that such a change would minimize the discrimination which it says now exists in favor of member banks in Federal Reserve Bank or branch cities. This suggestion, which has nothing to do with the proposed revision of Regulation D, would seem to be completely undesirable because it could result in substantial operating difficulties and would significantly increase float.

received by the Federal Reserve Bank of the district in which the city is located from one or more member banks with head offices in such city and if such request is granted by the Board of Governors.

New Reserve Cities

The banks in Hartford, Albany, Newark and Phoenix argue that the cities in which they are located should not be made reserve cities because--

1. Curtailment of lending power, due to higher reserves, would have a detrimental effect on area economy. (Albany, Hartford, and Phoenix)

2. Deposits held by branches outside of the head office cities account for a large proportion of total demand deposits. (Albany, Hartford, and Phoenix)

3. Fully secured public funds account for a large proportion of total demand deposits. (Albany)

4. The ruling is arbitrary, discriminatory, unreasonable, and out of harmony with the intent of Congress. (Newark)

The counter-arguments to those presented by the protesting banks are:

1. The law requires that banks be divided into two groups and the only question is whether banks with similar characteristics, from the standpoint of function of reserve requirements, are treated alike. Many, perhaps most, existing reserve cities might contend that their ability to meet loan demands in their communities is being hampered by the reserve requirements applicable to them. It may be noted that in some cases this argument is used on the grounds that the area is depressed, whereas in Phoenix lower requirements are said to be needed to meet the demands of a growing community. Current Federal Reserve policies with respect to the over-all availability of reserves are designed to provide for the credit needs of the economy in general; the distribution of these resources among areas and banks is determined by the working of a variety of market and other economic forces beyond the control of the Federal Reserve.

2. It is true that a large portion of deposits in branches--particularly those located in small communities--are more nearly similar to country bank deposits than to reserve city bank deposits, but large branch banks are in position to, and in most cases do, engage in activities and hold

substantial amounts of deposits of a nature similar to those in large unit banks. Moreover, in branch banking, the relationship between a head office and its own branches serves as a substitute for correspondent banking and the function of interbank deposits is effectively served, even though there is no substantial volume of deposits carried for other banks.

Branch deposits are subject to the over-all lending and investment policies of the head office management. Furthermore, any attempt to separate branch deposits from those attributed to the head office would involve administrative and regulatory difficulties of an insurmountable nature.

3. From the standpoint of the function of reserve requirements, namely limitation on credit expansion, there is no basis for distinguishing between public funds and other deposits. They are all a part of the process of multiple credit expansion. With respect to their effect upon the volume of spending in the economy, it has long been recognized that public funds have a higher rate of turnover than other demand deposits. The material furnished by the Albany banks indicates the velocity of public funds is double that of the other deposits. Higher reserve requirements would tend to minimize the erratic effect of these deposits on the money market.

4. The present alignment is discriminatory and unreasonable because it permits country bank status for some cities that have significant characteristics essentially similar to existing reserve cities. The Board's objective was to remove as many of these inequities as was possible with a minimum disturbance. Recent Congressional action would seem to support criteria which take into account general character of business. Tests of various possible criteria indicate that total demand deposits provide a simple standard that gives about the same results as other more complex formulas. The cities that have been added to the list of reserve cities have characteristics that are similar to many cities now so classified. It would not be feasible to evolve and apply equitably a standard that would leave out these cities, without eliminating a number of existing reserve cities.

Need for Guidance

Ordinarily in a project of this nature the relevant material would be submitted to interested members of the Board's staff for consideration and suggestions concerning recommendations to be made to the Board. In view of the time element in this case, however, we are taking the liberty

of submitting the following suggestions (which illustrate one position the Board might take) without having had the usual benefit of full staff consideration. While the Board may wish to take some other position, our thought was that whatever it decides with regard to these suggestions will give the staff guidance in the preparation of such material as may be appropriate for final action. For instance, the staff could begin working on appropriate drafts if the Board should decide to inform the Reserve Banks that--

1. It has considered the protests to its proposed procedure for classifying reserve cities and has adopted the original proposal with the minor changes suggested herein.

2. It is sending a reply to each of the protesting banks and copies of these replies to each of the Reserve Banks concerned.

Other alternatives to the procedure proposed in Item 2 above would be, in lieu of replies to the individual banks, to make only a short announcement along the lines indicated in Item 1 above, or to issue a general statement giving some of the reasons for the Board's action. The suggestion for individual replies is based on a belief that the protesting banks would feel better if they had some indication that their points had been carefully considered rather than summarily dismissed. Individual replies seem better suited for this purpose than a general statement because of differing points raised by the various banks. For instance, the question of public funds was raised only by the Albany banks and the charge of capricious action was made only by the Newark banks. Accordingly, it would seem undesirable to refer to these points in a general statement.

Related Matters

In addition to protesting against the proposals to designate their cities as reserve cities, the following banks have requested permission to carry reduced reserves if the proposed reserve city classification standards are adopted:

National Commercial Bank and Trust Co., Albany, N. Y.
First Trust Company, Albany, N. Y.
Savannah Bank and Trust Co., Savannah, Ga.
Valley National Bank, Phoenix, Ariz.

Of these four banks, the Savannah Bank and Trust Company is clearly eligible,[1] but the First Trust Company of Albany request would

1/ Demand deposits of this bank total about $27 million. Although the bank indicated a strenuous objection to the designation of Savannah as a reserve city, this protest appears to be based on a misunderstanding of the Board's intention to permit it to carry reduced reserves. In this light, the protest was not included among the earlier comments in this memorandum concerning banks objecting to the designation of new reserve cities.

seem to require more information regarding the character of its business before further consideration. There would appear to be no basis for granting the requests of the National Commercial Bank and Trust Company and the Valley National Bank becuase they are the largest banks in their respective cities.

Under the Board's proposed rule banks in present reserve cities which would lose this status under the new plan have until May 15, 1961, to request continuation of their reserve city status. In this connection requests have been received from the First National Bank of Pueblo, Colorado (the only reserve city bank in Pueblo), and from two Toledo banks (The National Bank of Toledo and the Ohio Citizens Trust Company). It is understood that The Toledo Trust Company, which has about $200 million of demand deposits and is the largest bank in the city, will submit a similar request.

It is suggested that the Board will want to defer action on the requests for permission to carry reduced reserves and for continuation of reserve city classifications at least until it has taken final action on the standards for classifying cities.