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Monthly Review

Using A Sharper Pencil?

Part II

A Study of Changes in Reserve Management at District Banks

Also in this issue:

INDEX FOR THE
YEAR 1965

SIXTH DISTRICT
STATISTICS

DISTRICT BUSINESS
CONDITIONS

*Federal
Reserve
Bank of
Atlanta*

Sixth District banks, which hold more excess reserves on average than all banks in the nation, are seeking to put their reserves to greater use. The first part of our study, in the November issue of the *Review*, briefly described the theory of reserve management and discussed our investigation of the current practices of District member banks in balancing their reserve accounts. The study revealed that large banks generally manage their reserve positions more closely than small banks. Daily reserve surpluses and deficits tend to vary within smaller limits, relative to required reserves, at large banks than at small banks. Furthermore, small banks tend to run larger surpluses and smaller deficits, relative to required reserves, than large banks. Since small banks run surpluses nearly all the time, they apparently make little attempt to use excess reserves accumulated during the statement period.

We will now take up developments in the United States during the past decade that theoretically should have induced cost-conscious bank management personnel in the Sixth District to put idle funds to work, or to cut back excess reserve balances by using sharper pencils in managing their reserves. We will then see whether they actually did change their reserve management practices, and if so, what methods they used.

Why Put Idle Funds To Work?

Interest rates, particularly short-term rates, have risen substantially over the past decade. For example, the rate on three-month Treasury bills has increased more than 2 percentage points since 1955. As interest rates rise, it becomes more costly to hold idle balances and more profitable to put them to work. Thus, higher interest rates in recent years must have encouraged banks to use their excess reserves.

A general awareness of these conditions has developed in recent years — particularly at smaller banks in various parts of the country. This knowledge has been stimulated in part by a squeeze on bank profits: Average interest expense on deposits has increased with the rising interest rates and the rapid flows of funds into time deposits concurrent with widespread economizing on demand deposit accounts. Increased knowledge has also been stimulated by bond dealers and the bond departments at large banks who, in trying to build up more business for themselves, have pointed out the rationale and methods for investing excess reserve balances.

The development and refinement of the Federal funds market, through which reserve balances are bought and sold, have enabled many banks to balance their reserves more closely. In addition, many small banks that earlier had been barred from participation by the size of the minimum trading unit now have access to the Federal funds market. This has resulted from offers of various large banks to enter into Federal

funds transactions with their small correspondents, not only in amounts of \$500,000 and over in which trading normally occurs but in smaller amounts — as low as \$100,000. Thus, excesses, or deficiencies, accumulated by small banks during the early days of the reserve settlement period may now be offset by sales or purchases of Federal funds from larger correspondents, resulting in a closer balancing of reserve averages with requirements. Many bankers feel safe in balancing reserves quite closely through purchases and sales in the Federal funds market, since they can normally cover sudden shortfalls at the discount window.

In the light of the foregoing developments, we would expect that District banks are balancing their reserves more closely than they did several years ago. If so, their excess reserves as a proportion of required reserves must have declined in recent years.

Have District Banks Used Sharper Pencils?

Have management personnel at District banks actually used sharper pencils in balancing their reserves? In a word, Yes. Average excess reserves per bank declined as did excess reserves, relative to required reserves. District banks reduced their excess reserve balances from 5.3 percent of required reserves in 1955 to about 3.4 percent during the first ten months of 1965. As shown in Chart I, the downward movement in this excess reserves ratio was interrupted by increases in 1958 and again in 1960-61. These interruptions partly reflect the effects of the recessions of 1957-58 and 1960-61, when the demand for loans declined as business activity contracted. At the same time, an easing of monetary policy led to an increased supply of lendable funds and a subsequent decline in interest rates. With the economic picture less optimistic and the cost of holding excess reserves somewhat lower, bankers probably decided to hold more excess reserves as a cushion against deposit losses.

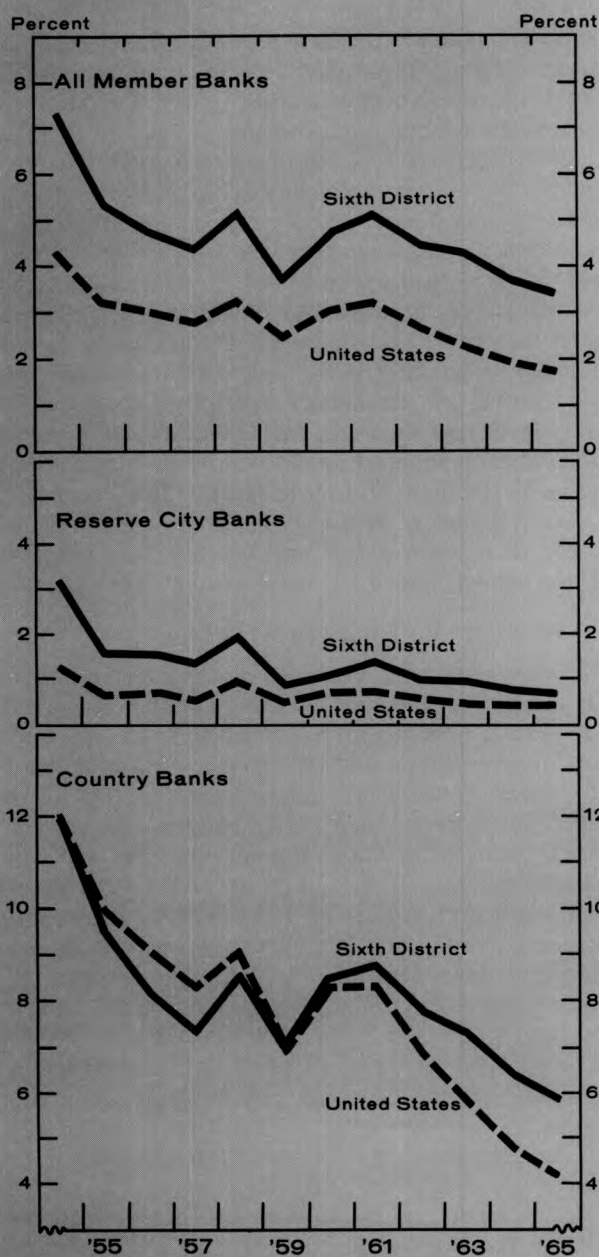
One additional factor figures prominently in the rise in excess reserves in 1960-61. Beginning late in 1959, the Board of Governors allowed member banks to count, first a part and then, by the end of 1960, all their currency and coin as legal reserves. The substantial amount of reserves created by this action took the form of excess reserves, which were gradually put to work as bankers adjusted to this new component of their reserve balances.

Some economists argue that vault cash has acted as a new source of reserve instability and that member banks now must hold more excess reserves as a buffer against swings in vault cash. If so, the effect of this factor has been offset by other forces, for excess reserves, relative to required reserves, have trended downward since 1961 to points below those reached before the vault cash action.

Having determined that reserve management personnel at District banks were using sharper pencils in managing their reserve balances, we wanted to know which group of banks were most active in this development. We found that all banks have reduced their excess reserve balances, relative to required reserves, but country banks have reduced theirs considerably more than reserve city banks. Excess reserves at country banks fell from 9.5 percent of required reserves in 1955 to an average of 5.9 percent in the first ten months of 1965 — a reduction of 3.6 percentage points. Reserve city banks, having managed their excess reserve positions closely for some time, cut excess reserves back over the period by 0.9 percentage points — from 1.6 percent of required reserves in 1955 to 0.7 percent thus far this year. The sizable reduction in excess reserves at country banks indicates that smaller banks in this part of the United States have taken advantage of recent developments in reserve management and money market techniques.

How do these changes in excess reserves at banks here compare with those elsewhere? In a nutshell, banks in this District may have sharpened their pencils a little

I: Ratio of Excess Reserves to Required Reserves
SIXTH DISTRICT AND U. S. MEMBER BANKS
1954-65



faster, although not quite to the same sharp point as banks in the entire nation.

Closer inspection shows that District reserve city banks apparently have improved their reserve management techniques more rapidly than reserve city banks in the U. S., lowering their excess reserve balances nearly to the national average for reserve city banks. On the other hand, District country banks have failed to reduce excess reserves as rapidly as country banks in the nation.

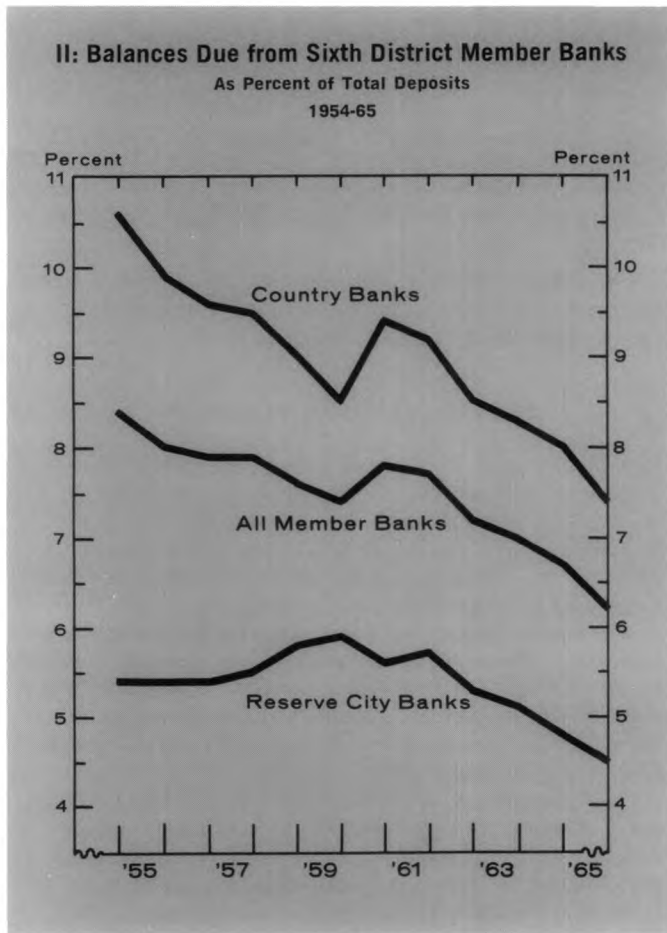
In terms of improved reserve management, a cutback in excess reserves would not be very meaningful if it were accompanied by a corresponding rise in other non-earning cash assets, or balances with other commercial banks. Minimal balances in these accounts are important, of course, since banks receive services in exchange for them. However, we would expect banks to have reduced non-essential balances in these accounts for much the same reason that they reduced excess reserves, namely, to maximize earnings within an environment of rising interest rates and of increasing knowhow in putting idle funds to work.

As shown in Chart II, District banks indeed did reduce their balances with other banks in relation to their total deposits. Although country banks effected the sharpest re-

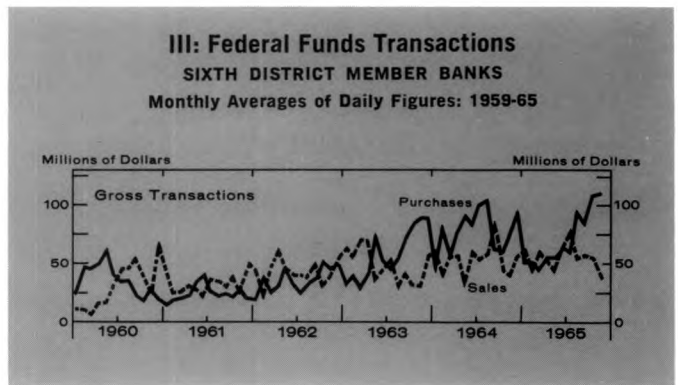
How Were Excess Reserves Reduced?

One important way District banks have responded to incentives to use a sharper pencil has been to borrow or lend more frequently to banks outside the District—and to each other—through purchases or sales of Federal funds. When one bank acquires the idle excess reserves of another, both banks benefit: The borrowing bank gets reserves at a rate which until early this year was normally below the discount rate and avoids any stigma attached to continued borrowing from the discount window; the lending bank invests funds for short periods at a reasonable rate with little risk.

Although the data are difficult to obtain and must be interpreted with caution, they indicate clearly that reserve management methods in the 1960's have been modified to include increased trading in Federal funds. The most reliable figures, shown in Chart III, are those for a sample of large banks in the District. Increases in amounts traded



duction, reserve city banks also reduced their balances with other banks to a point still somewhat below the country bank averages. The sizable reduction in balances with banks brings us to the conclusion that the decline in excess reserves is real, and not simply a transfer of funds from one non-earning asset to another.



by certain banks are illustrated in the chart, but the scope of Federal funds trading is not fully depicted. Special studies of District banks, conducted at irregular intervals since 1956, indicate that the number of banks trading increased more rapidly than the total volume of purchases and sales. To cite the extremes, about 15 banks were trading at the time of the 1956 and 1958 studies, and about 75 banks traded Federal funds in April of this year. Since the methods we used in these studies almost certainly underestimate both the amount of trading and the number of banks, the absolute increase is probably greater than these figures show.

The April study revealed an interesting facet of the Federal funds market: Even though transfers of \$1 million or over accounted for more than 95 percent of the total dollar amount of Federal funds transfers in the District, 300 transactions were in amounts of less than \$1 million. Moreover, nearly 200 transfers were less than \$500,000 each. Some of these transfers were purchases of Federal funds by small District banks, which supports the notion that District bankers are becoming more sophisticated in managing their reserves. Many of the small transactions reflect larger District banks' purchases of Federal funds from small correspondents made in order to keep their accounts.

A continuing need for funds by large District banks could further increase Federal funds trading in small amounts. Some large District banks are presently attempting to establish local sources of Federal funds, which

might continue to provide funds if the usual sources, the large money market banks in New York, Chicago, and the West Coast, should dry up. It seems likely that trading for periods of more than one day—not often found in larger transactions—will become more frequent as both buying and selling banks try to minimize “handling costs” of Federal funds transactions. Smaller banks, however, may increasingly enter the market on the borrowing side as their reserve management becomes more refined and their excess reserves decline. They may be looking to the larger banks in the District as sources as well as outlets for funds. These developments are minor, relative to the total amounts of trading, but they are interesting.

Trading in Federal funds, though important, must be viewed as but one of several important developments in the evolution of reserve management. As Chart IV shows, during the past ten years borrowing from the System by District banks increased as the economy expanded and borrowing receded as it contracted. Also, the ratio of ex-

cess reserves in reserve management methods, but it is equally true that the nature of deposits has changed radically over the same time span. With the growth in deposits, required reserves have increased more rapidly than the need for a cushion of excess reserves. Larger banks can afford to devote more time to reserve management, and more deposits per bank generally reduce the likelihood of wide variations in deposits. Also, since a large percentage of the growth in total deposits has been in time deposits, total deposits should be more stable and, consequently, changes in reserve positions more moderate.

The growth in deposits has also altered the flexibility of the Government securities portfolio. Reserve managers have less freedom to use portfolio changes to adjust their reserve positions now that the Government securities portfolio is much smaller, relative to total deposits, and a greater portion of these securities is pledged as collateral for deposits. As the ability to change the Government portfolio has decreased, however, the possibilities of acquiring funds from other sources have increased. Bankers can vary the rate of acquisition of funds by changing the rates and amounts of promotional efforts for certificates of deposits, savings certificates, and short-term unsecured notes. Although some District banks have been active in promoting savings certificates and certificates of deposits and a few have issued short-term unsecured notes, these methods have not yet been widely utilized in this District.

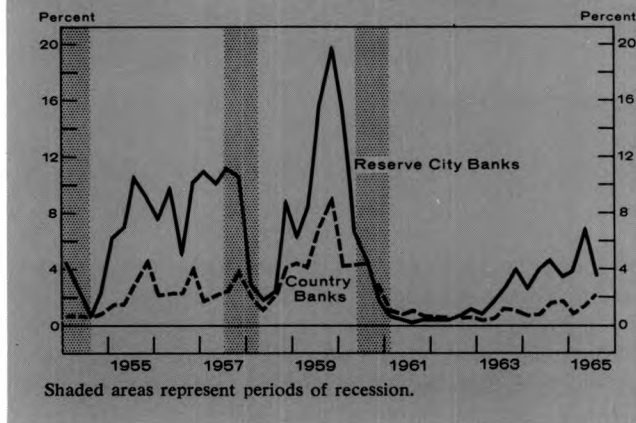
PAUL A. CROWE

ROBERT R. WYAND II

This completes a two-part series on a study of reserve management at District banks during the past decade. Part I of “Using a Sharper Pencil?” appeared in the November 1965 REVIEW. Copies of both articles are available upon request to the Research Department, Federal Reserve Bank of Atlanta, Atlanta, Georgia 30303.

IV: Ratio of Borrowings from the Federal Reserve Bank to Required Reserves

SIXTH DISTRICT MEMBER BANKS
Quarterly Averages: 1954-65



cess reserves, although exhibiting a general downward trend, rose in periods of contraction. We can infer from this that bankers responded to credit expansion squeezes on their reserve positions by trimming their excess reserves and borrowing more frequently from the System. Part of the pressure to borrow at the discount window was alleviated by the development of the Federal funds market, which would help explain the delay in the upturn in borrowing during the present expansion. The increased borrowings in 1964 and 1965 may partly reflect a return to the discount window now that the possibilities of inter-bank borrowing have been more fully exploited. A Federal funds rate generally above the discount rate, which has prevailed most of this year, supports this contention.

The discussion of reserve management methods is incomplete without a consideration of factors other than the manipulation of reserve accounts by borrowing and lending reserve balances. Clearly, the nature of the loan and investment portfolio and the structure of deposits affect the need for the manipulations discussed so far. True, excess reserves, relative to required reserves, have been reduced in the past ten years, indicating improve-

Bank Announcements

The COHUTTA BANKING COMPANY, Chatsworth, Georgia, a nonmember bank, began to remit at par for checks drawn on it when received from the Federal Reserve Bank on November 1. Officers are R. E. Chambers, President; L. P. Huff, R. K. Richardson, and Jack Greeson, Vice Presidents; and Frances Heartsell, Cashier.

Also on November 1, the BROOKHAVEN BANK AND TRUST COMPANY, Brookhaven, Mississippi, a nonmember bank, began to remit at par. Officers are S. E. Babington, President; F. F. Becker II, Executive Vice President; R. L. Davis, Senior Vice President; T. E. Applewhite, Vice President; and F. J. Rein, Cashier.

On November 4, the UNIVERSITY NATIONAL BANK OF BOCA RATON, Boca Raton, Florida, a newly organized member bank, opened for business and began to remit at par. William M. Stowe is President, and Kenneth N. Bradshaw is Executive Vice President and Cashier. Capital is \$250,000; surplus and other capital funds, \$250,000.

The REPUBLIC NATIONAL BANK OF MIAMI, Miami, Florida, a newly organized member bank, opened for business on November 8 and began to remit at par. Officers are Ernest Janis, President; R. J. Grazier, Executive Vice President; William A. Rushton, Vice President and Cashier; Bernard Janis and Simeon D. Spear, Vice Presidents. Capital is \$250,000; surplus and other capital funds, \$375,000.