For release on delivery
Thursday, April 26, 1973
10 a.m. EST

The Structure of Reserve Requirements

Address by
Arthur F. Burns
Chairman, Board of Governors of the Federal Reserve System

before the
Governing Council Spring Meeting
American Bankers Association

White Sulphur Springs, West Virginia

April 26, 1973

THE STRUCTURE OF RESERVE REQUIREMENTS

by

Arthur F. Burns

It is a pleasure for me, both as a citizen and as a government official, to join in the deliberations of this Council. We share many common objectives and we face common problems. Of course, our views have not always agreed in the past, and I doubt if the future can or will be entirely different. It is important, nevertheless, that we make a conscientious effort to understand one another's perceptions of the problems we face. If we do so, we will generally find a path to fair and constructive solutions.

One gratifying demonstration of that fact has taken place in recent weeks. The Committee on Interest and Dividends recently issued guidelines on the so-called "dual prime rate." In response to my invitation, bankers from all over the country met with the Committee and its staff to ponder the difficulties surrounding the prime rate in the current environment and to seek a solution that could best serve the public interest. I am especially grateful to two of your leaders, Eugene Adams and Rex Morthland, for giving so generously of their time and wisdom to make the lending rate guidelines fair and workable. And I also want to note that the banking industry has acted prudently in complying with the Committee's request to move gradually and cautiously in adjusting the prime loan rate for large businesses. Such a moderate response adds to national confidence in the public responsibility of banking leaders.

Today, however, I shall say no more of the Committee on Interest and Dividends, but turn instead to my responsibilities as Chairman of the Federal Reserve Board. You and I have a number of pressing problems demanding our immediate attention. But it is also essential that we focus on longer-range issues from time to time. I want to discuss with you one of those issues this morning -- namely, the structure of reserve requirements.

This is a subject of substantial interest to the managers of commercial banks. It is also a matter of considerable importance to those of us concerned with the nation's economic and financial policy. For reserve requirements can influence in fundamental ways the effectiveness of monetary policy, the cost of financial intermediation, and the allocation of savings among competing financial institutions.

Let me begin by considering the role and purpose of reserve requirements in the functioning of monetary and credit policies.

Before the Federal Reserve System was founded, reserve requirements were imposed by legislation at the national and state levels as a means of protecting bank liquidity. That philosophy was retained in the original structure of reserve requirements established for Federal Reserve member banks. Higher requirements were set for reserve city banks than for country members, and still higher requirements were imposed on central reserve city banks. Vestiges of that initial structure remain, even today.

Required reserves, however, are not really an important source of bank liquidity. The reserves required to back deposits cannot be withdrawn to finance a rise in loan demand, and they can supply only a small portion of the funds needed to accommodate deposit losses. The true and basic function of reserve requirements is not to provide liquidity, but to permit the Federal Reserve to control the supply of money and credit so that monetary policy can effectively promote our national economic objectives.

To achieve good management over the supply of money and credit, reserve requirements must be met by holding assets whose aggregate volume is under the control of the Federal Reserve. Whatever their role may be in protecting bank liquidity, the reserve requirements set by the various states do not meet this test. This is a serious defect, since the principal reason for reserve requirements is their contribution to effective monetary policy.

Judged by this criterion, the present structure of reserve requirements leaves much to be desired. Reforms are needed to increase the precision and the certainty with which the supply of money and credit can be controlled. Reforms are needed to permit more variation in reserve requirements as an instrument of monetary policy. Reforms are also needed to distribute the burden of monetary controls more equitably among the financial institutions that participate in the payments mechanism.

The Federal Reserve Board has been concerned for some time with inequities in the structure of reserve requirements. Last November, we finally used our authority under Regulation D to carry out substantial improvements in the structure of reserves that are required to be held against the demand deposits of member banks.

As you know, the Federal Reserve Act specifies that the Board must distinguish between reserve city banks and other members in the establishment of reserve requirements. Until November 1972, the principal determinant of a bank's reserve status was its geographic location. Banks in principal financial centers were generally classified as reserve city banks; those in other locations fell into the country member category. A bank could, however, have its classification changed by appealing for special treatment based on the nature of its banking business.

With the passage of time, this system of reserve classification became increasingly outmoded and inequitable. Some large banks in cities of substantial size enjoyed the lower reserve requirement on demand deposits applicable to country members. At the same time, there were some small banks in major financial centers that had to carry the higher reserve requirement imposed on reserve city members. Over the years, exceptions had been granted in so many cases--each of them probably justified but different from most others--that the principles underlying the reserve classification of member banks could no longer be readily discerned.

The Board moved last year to eliminate these capricious elements in reserve classification by introducing a graduated reserve requirement--that is, by relating the reserve against demand deposits of each bank to the size of the bank. Under the new system, all member banks of a given size, whatever their location, are subject to identical reserve requirements.

This reform was a major step forward in the creation of a more rational and equitable structure of reserve requirements. Yet, much more remains to be done.

One of the principal steps needed is to apply equivalent reserve requirements to member and nonmember banks. At present, nonmember banks are not required to hold reserves in the form of deposits at the Federal Reserve Banks, as member banks do.

In many States, percentage reserve requirements for nonmember banks are comparable to those for Federal Reserve members. However, the reserves required of nonmember banks usually may be carried as correspondent balances, or even in the form of government securities. When reserves are held as correspondent balances at a member bank, that bank is of course required to support these balances with reserves that consist either of vault cash or cash at the Federal Reserve. But in such a case the size of the cash reserve held by the member bank is quite small relative to the initial deposit at the nonmember bank.

The consequence of these differential reserve requirements is that shifts of deposits between member and nonmember banks alter the quantity of deposits at all commercial banks that can be supported by a given volume of bank reserves. Thus, the links between bank reserves, on the one hand, and bank credit and the money supply, on the other, are loosened, and the Federal Reserve's control over the monetary aggregates becomes less precise than it can or should be.

The magnitude of this problem is difficult to assess, since nonmember banks submit statistical reports to supervisory authorities infrequently. Annual data, however, suggest a substantial variability in the relative growth rates of member and nonmember banks. Over the past decade, increases in the volume of checking deposits at nonmember banks accounted for around 40 per cent of the total rise in checking deposits. But the proportion was as low as one-tenth in 1962 and as high as three-fourths in 1969. Variations of this magnitude add to uncertainty about the effects of open market operations on bank credit and deposits, on the cost and availability of loanable funds, and hence also on the level of aggregate demand for goods and services.

This source of imprecision in monetary control has become more worrisome as the proportion of bank deposits held at member banks has declined. In 1945, 86 per cent of total commercial bank deposits was held by member banks. The ratio had fallen to 80 per cent by 1970 and to 78 per cent by the end of last year.

In part, this trend reflects the relatively rapid growth of population in areas served by nonmember banks, particularly suburban areas. The major causal factor, however, is the competitive disadvantage that is imposed on member banks by requiring them to hold reserves against deposits in the form of vault cash or as deposits at the Federal Reserve. For nonmember banks, required reserves are, in effect, earning assets even when they are held as demand balances with other commercial banks, since these balances normally also serve as a form of payment for services rendered by city correspondents.

One consequence of this inequity is an incentive for member banks to withdraw from the Federal Reserve System, or for newly-chartered State banks to avoid Federal Reserve membership. Since 1960, about 700 banks have left the System through withdrawal or mergers. Just over 100 State-chartered banks have elected to join the System since 1960; nearly 1,500 others receiving new charters chose to remain outside the System.

And the trend continues. During 1972, five banks with deposits of $100 million or more withdrew from Federal Reserve membership. Of the 212 new commercial banks receiving State charters last year, only 13 elected Federal Reserve membership.

Over the years, efforts have been made to reduce the competitive disadvantage faced by member banks and thereby make System membership more attractive. Permission to count vault cash in meeting reserve requirements clearly improved matters. The changes made in Regulation D last November were also helpful, because they reduced reserve requirements against demand deposits--particularly for small member banks that compete actively with nonmembers. Recently, a seasonal borrowing privilege at the discount window was established for member banks that have insufficient access to the national money markets. This, too, should make membership more attractive. Nevertheless, there are limits to measures of this kind that can be taken under existing legislation.

The erosion of membership in the Federal Reserve System is therefore a serious problem. It reduces the precision of monetary control, as I have already noted. It may, in time, also weaken public confidence in the nation's central bank and in its ability to maintain a stable currency and a sound banking system. And it has already reduced the potential for using changes in reserve requirements as an effective instrument of monetary policy. When a large and increasing proportion of total bank deposits is left untouched by changes in the reserve requirements prescribed by the Board, that alone is a fact of some significance. The greater loss, however, arises because the Board must use changes in reserve requirements sparingly as an instrument of monetary policy, since an increase in required reserves would worsen the competitive disadvantage of member banks and thereby threaten a further erosion of membership.

This inhibition has been unfortunate, for there have been times when the prompt and pervasive impact of a higher reserve requirement would have been the best way to signal that monetary policy is moving toward added restraint on the availability of money and credit. In view of the divergence in reserve requirements between member and nonmember banks, the Federal Reserve has sometimes had to turn to other, perhaps less effective, measures to achieve its objectives.

These considerations argue persuasively, I believe, that reserve requirements on demand deposits at nonmember banks should be the same as those faced by Federal Reserve members. Continuation of the present state of affairs is inequitable, and it also weakens monetary control. These difficulties will become more acute in the years to come if corrective legislative action is not forthcoming.

The proposal to treat member and nonmember banks alike for reserve purposes is not new. Its substance was embodied in the recommendations of a Congressional committee chaired by Senator Douglas in 1950, repeated in 1952 in the recommendations of a Congressional committee chaired by Congressman Patman, endorsed by the Commission on Money and Credit in 1961, reaffirmed by the President's Committee on Financial Institutions in 1963, and restated again in the 1971 report of the President's Commission on Financial Structure and Regulation. Since 1964, the Federal Reserve Board has repeatedly urged the Congress to bring all insured commercial banks under the same reserve requirements, and to provide all these banks with equal access to the discount window.

I am aware that this proposal is not viewed with favor by many segments of the banking community, and that is the major reason why this needed reform has been delayed. The proposal would be more palatable to bankers if some part of the Board's reserve requirement against demand deposits could be held in the form of an earning asset, such as U.S. Government securities. I do not want to rule out that possibility categorically. Simple honesty, however, compels me to state that, however attractive reserve requirements in that form may be from the standpoint of bank earnings, they cannot serve a useful function in monetary management. As I noted earlier, satisfactory control over the supply of money and credit requires that bank reserves be held in the form of assets whose aggregate volume is directly controlled by the Federal Reserve.

The principle that underlies the Board's recommendation is simple and straightforward--namely, that equivalent reserve requirements should apply to all deposits that effectively serve as a part of the public's money balances. Recent efforts of nonbank depositary institutions to evolve new modes of money transfer make adoption of this principle a matter of some urgency. If legislative action is delayed, we may soon find a much larger share of money transfers taking place at institutions outside the reach of the Board's reserve requirements.

As you know, participation in third-party transfers by nonbank financial institutions has already commenced. In Massachusetts and New Hampshire, mutual savings banks have begun to offer depositors an interest-bearing account subject to a negotiable order of withdrawal--a "NOW account"--that resembles closely an interest-bearing checking account. In California, savings and loan associations are seeking direct access to an electronic money transfer system operated by California banks. Access to the system would enable these associations to charge and credit the savings accounts of their customers in much the same way that checking deposits are handled at commercial banks. Other forms of third-party transfers are likely to spring up here and there.

The Board believes, and has so indicated in testimony to the Congress, that Federal regulation should permit developments such as these to flourish, so that the range of services of depositary institutions to American families may be extended. The Board believes, however, that present trends could have significant adverse effects on monetary control unless reserve requirements established by the Federal Reserve are applied to all deposit accounts involving money transfer services. Failure to do so would also have damaging effects on competitive relations between commercial banks and non-bank thrift institutions.

Universal application of reserve requirements to all deposits providing money transfer services need not mean a uniform percentage requirement on all these deposits. There may be a reasonable basis for lower reserve requirements on savings accounts with third-party transfer privileges than for deposits that carry full checking account powers. There may also be a reasonable basis for retaining the principle of reserve requirements graduated by size of the depositary institution. Lack of uniformity of reserve requirements on similar deposits does, however, pose potential problems for monetary control.

There are other aspects of present reserve requirements that also deserve careful and continuing review in the light of our evolving financial structure.

The appropriateness of reserve requirements on commercial bank time and savings deposits has been a subject of debate over the years. It has been argued that cash reserves against time deposits are not essential for purposes of monetary control, and therefore should be abolished as an unnecessary impediment to intermediation. Yet, some observers take the position that reserve requirements for commercial bank time deposits should be increased to the same level as the requirements for demand deposits, so that shifts of funds between the two deposit classes would not alter the relation of bank reserves to bank credit and the money supply.

The merits of these conflicting arguments are difficult to evaluate. At present, there is no convincing evidence of frequent, or large-scale, shifts of funds between demand and time deposits of the sort that could be disruptive to financial markets and to the management of aggregate demand. Still, the potential for such shifts may be increasing with the proliferation of new financial services that facilitate transfers from one type of deposit to another.

Removal of reserve requirements against time deposits would, therefore, seem unwise at this time. And in any event, elimination of statutory authority to impose reserve requirements against time and savings deposits would take away a weapon of monetary policy that is potentially useful for containing increases in bank credit at a time when inflationary pressures are already strong and threaten to become still stronger.

As long as commercial banks are required to hold cash reserves against time and savings deposits, questions will persist about the desirability of similar requirements against savings accounts at nonbank thrift institutions. At present, extension of reserve requirements to savings accounts at nonbank intermediaries does not appear to be needed for reasons of monetary control.

There have been times when shifts of funds between banks and nonbank intermediaries have had a disturbing influence on the mortgage market. But those shifts have not produced serious problems for monetary control, and they would not have been prevented by comparable reserve requirements at the two classes of institutions.

From the viewpoint of equity, the case for equal reserve requirements on time and savings deposits at all financial institutions is stronger. Even on this ground, however, it should be kept in mind that the diversified services that commercial banks offer their customers gives them an advantage in bidding for time and savings deposits--an advantage that probably still remains after the costs of holding cash reserves are taken into account.

However, if recent trends continue, the increasing provision of money transfer services by nonbank thrift institutions will blur the distinction between commercial banks and nonbank intermediaries, just as it blurs the distinction between checking and savings accounts. As nonbank depositary institutions become more like commercial banks, the basis for differences in reserve requirements will be weakened and so too will the justification for differences in tax and regulatory treatment.

Public policy must take account of the competitive forces that are altering the structure of our nation's depositary institutions and the character of the services they supply. The need for legislation authorizing identical reserve requirements on demand deposits at member and nonmember banks is of long standing. The time for bringing NOW accounts and any other deposits offering money transfer services under the Board's reserve requirements is clearly at hand. And if the distinctions between commercial banks and nonbank financial institutions gradually fade away, regulatory authority to equalize the treatment of time and savings deposits for reserve purposes will also be needed.

Enabling legislation to accomplish these ends should allow flexibility in implementation. The transition to a new and more appropriate system of reserve requirements should be designed so as to minimize the adjustment problems of individual institutions, and also permit the regulatory authorities to monitor the effects of changing reserve requirements on financial markets and on economic activity. Abrupt changes in the structure of reserve requirements are unnecessary and would probably be unwise. The need, as I see it, is for a gradual transition to a reserve structure that will accomplish two objectives: first, ensure adequate control over the supply of money and credit in the years to come, and second, establish an equitable sharing among financial institutions of the costs of monetary control.