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Statement by

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before the

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Committee on Banking, Housing and Urban Affairs

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I am very pleased to testify today on behalf of the Federal Reserve Board in support of S. 1664. This proposed legislation addresses two problems: first, the distortions caused by the rather haphazard spread of the payment of interest by depository institutions on transactions balances; and second, the withdrawal of banks from Federal Reserve membership because of a growing sensitivity to the financial costs of membership.

These are serious matters for our economy, as I trust my testimony will make clear, and they are closely interrelated. The bill before you deals with them in an integrated way. I cannot emphasize too strongly the Board's view that the two major elements of this legislative package are inseparable. Despite our concern about the piecemeal and capricious manner in which the Nation's financial institutions have been moving toward the payment of interest on transactions balances, we could not support nationwide extension of NOW account authority if that extension were not coupled with action to lighten the burden of Federal Reserve membership. The risk to the safety and soundness of our banking system of enacting the first part of the package without the second would, in the Board's judgment, be intolerably large.

The bill as it stands deals constructively with both matters, and the Board thus supports its basic thrust with enthusiasm.

In our view, this bill will serve to enhance both consumer equity and competitive balance among financial institutions; it also will repair in significant measure the weakening of our banking structure that has been in process because of the erosion of Federal Reserve membership.

The first major provision of this legislation authorizes the payment of interest on transactions balances held by consumers in the form of NOW or share draft accounts. It thus seeks to extend and regularize a financial trend that has been developing for some time. The prohibition on the payment of interest on demand deposits enacted in the 1930's did not actually end such payments; rather it changed their form. In the case of individuals, commercial banks have been providing an implicit return on demand accounts in the form of free services or of service charges below bank costs. The Board's staff estimates that such services received by individuals are now equivalent, on average, to a rate of return of nearly 5 per cent on their demand deposits.

Reflective of competitive pressures, an implicit interest rate return is also being paid by banks on the demand accounts of businesses and other economic units, such as State and local governments. Large spending units have acquired the sophistication and skill to minimize the balances on which they receive an implicit return; that is to say, they have been increasingly investing their surplus funds in short-dated money market instruments, such as certificates of deposit or Treasury bills, that can be readily converted into transactions balances. This, in effect, gives them an explicit return on a major part of their transactions balances.

An explicit interest rate return has one important advantage over an implicit rate of return: it is usable for any purpose the recipient elects rather than just for the purchase of bank services. In some degree, consumers, smaller businesses, and governmental units have also begun to enjoy explicit returns on transactions balances. This development reflects a broad range of competitive, legislative, and regulatory innovations in recent years that have facilitated shifts between savings and demand accounts or directly authorized the payment of interest on what for all practical purposes are demand balances.

Since 1970, these innovations have included the following: limited pre-authorized transfers from savings accounts by depositors in banks and savings and loan associations; NOW accounts, at first available only at mutual savings banks in Massachusetts and New Hampshire, and more recently at practically all depository institutions in New England; resort to withdrawals of cash from money-market mutual funds by negotiable draft; the use of credit-union share drafts; the ability to transfer funds by telephone from savings accounts to demand deposits; resort to payments to third parties from savings deposits on instructions transmitted by telephone or otherwise; and the use of electronic terminals located in retail establishments so that savings and loan customers can make direct payments to merchants from savings accounts. In order to share in the opportunities that have been made possible by these innovations, consumers -- of course -- have to live in New England, or be members of a credit union offering share drafts, or live in an area outside New England where financial institutions offer a special payments plan, or more generally, be sophisticated enough to be aware of the available alternatives.

The broad movement toward explicit interest on transactions balances has eroded the distinction between demand deposits and time or savings deposits, and it has significantly altered competitive relationships among institutions. This movement, moreover, continues to gain momentum and, in the judgment of the Board, has become irreversible. The question, therefore, is not whether we can stop it. The issue, rather, is whether we should try to give more specific guidance to an evolutionary process that so far has been haphazard and piecemeal -- entailing, as a consequence, sundry inefficiencies, such as the maintenance of dual accounts by depositors, and various inequities, such as those to consumers to which I have already referred. If no broad Federal reform is made, the trends that I have described will continue, with benefits to consumers to be sure, but with the creation of new inequities and with unnecessary inefficiencies.

Simple prudence suggests that the movement toward explicit payment of interest on transactions balances ought to proceed more deliberately than it has to date. Nationwide NOW and share-draft accounts limited to individuals, as proposed in S. 1664, would be a logical next step in the evolutionary process. That step would certainly result in greater equity for consumers -- especially those who lack financial sophistication. It might also permit individuals to earn more on their transactions balances than they now earn in implicit form. The New England evidence suggests that, at least in the short run, the combination of implicit and explicit payments would be appreciably larger than the implicit return that consumers now earn on their demand deposits. In time, of course, depository institutions could be expected to impose service charges in an effort to recover at least part of the costs of offering NOW accounts. They are also likely to be prodded to productivity gains which will limit the need for cost offsets. In the end, heightened competition for consumer deposits that would develop among depository institutions, together with economizing by consumers in the use of checks, could well result in a rate of return to consumers above current levels.

Not only would NOW accounts be advantageous to consumers, they could also produce benefits to the Nation's mortgage market. Experience teaches that transactions balances are more stable over the business-cycle -- that is, less sensitive to changes of interest rates -- than are time and savings accounts. Hence, as NOW accounts grow, the flow of deposits to thrift institutions should tend to stabilize. Such a development may ease the strains of disintermediation that these institutions have to cope with at times of credit tightness, and by so doing make the flow of mortgage funds somewhat more stable.

Despite the potential benefits of NOW accounts, they obviously will involve costs for financial institutions that must be carefully weighed by the Congress. If NOW account authority is extended, the thrift institutions availing themselves of the authority will be faced with new expenses in providing check services, while commercial banks offering NOW's will face the need to adjust to explicit interest on transactions accounts after almost 45 years during which such payments were prohibited. Experience with NOW accounts in New England indicates that commercial banks suffer the largest relative decline in earnings when NOW's are offered. That is to be expected because it is their transactions balances that have the greatest likelihood of being converted into NOW form.

Analysis by the Federal Reserve's staff suggests that the transition burden of NOW accounts on bank profits is likely to be heaviest some two to three years after the effective date of the legislation and that thereafter it can be expected to decline gradually -- perhaps being entirely eliminated in time. This expected cycle is predicated on an assumption that the initial stages of transition are likely to be dominated by an intense and quite costly competitive struggle for market shares, which will give way gradually to a situation in which competitors pay more attention to costs and to the establishment of appropriate service charges. Our staff calculates that at the point when profits are depressed most severely, the pre-tax earnings of commercial banks are likely to be running, on average, 5 to 6 per cent below the level that would prevail in the absence of nationwide NOW accounts for individuals.

This estimated worst-point impact on profits is less than the impact being experienced currently in New England, partly because the competitive struggle between thrift institutions and banks for NOW accounts is not likely to be as severe in most parts of the country as it has been in New England and partly because the proposed legislation structures NOW-account authority differently from the way it is used in New England. I must note, however, that the estimates of the profits impact of nationwide NOW-account authority involve assumptions that may prove to be incorrect. And I must also note that the indicated average profits shortfall of 5 to 6 per cent could be appreciably exceeded by individual institutions -- those, for example, whose present deposits happen to be weighted heavily toward consumer demand deposits or those that happen to be situated in communities in which competition becomes especially intense.

The Board is very much concerned about the implications of an adverse impact on bank earnings during the transition to a nationwide NOW environment. The potential impact on bank profits is a key reason for the particular structure of the legislative package embodied in S. 1664. Unless their profits are reasonably well maintained, banks will not be able to serve adequately their communities or support effectively the expansion of our national economy.

To minimize transition costs, S. 1664 limits eligibility for NOW and share-draft accounts to individuals -- leaving for another day, when we have more knowledge of the impact and adjustment processes, any extension of such accounts to a broader range of depositors. The objective of minimizing transition costs is also the reason for requiring that the maximum interest-rate on NOW accounts be set for a time below the rate on savings deposits at banks, and for the provision that would establish a reserve-requirement range for NOW accounts that is lower than the existing demand-deposit range. The bill, moreover, contemplates that the operative provisions of the legislation will not become effective until one year after enactment. This is intended to give financial institutions time for rational planning of their operational systems and marketing strategies, as well as to allow States time to adjust their statutes and regulations.

Efforts to minimize the transitional costs of NOW accounts are important for all banks, particularly so in the case of Federal Reserve member banks. As you know, a substantial number of banks have given up membership in the System in recent years, the preponderant reason being to escape the financial burden that membership entails. Most nonmember banks can hold a significant portion of required reserves in the form of earning assets. Member banks, on the other hand, must keep their reserves entirely in non-earning form. The burden of Federal Reserve membership thus consists of the earnings that member banks forego because of their high cash reserves relative to those of nonmember banks; these foregone earnings must, of course, be adjusted for the monetary value of the services to member banks that are rendered by the Federal Reserve banks.

It is obvious from the trend in Federal Reserve membership that more and more banks are becoming acutely aware of the cost burden of membership and of the competitive handicap arising from that burden. In 1976, 46 banks chose to give up membership and 9 banks left the System as a result of mergers with nonmembers. Over the past eight years a total of 430 member banks have withdrawn from the System, and an additional 90 have left as a result of merger. Whereas most of the banks withdrawing from membership during this period were small, a trend has also developed recently toward departure by larger banks. Of some 42 banks that withdrew from the Federal Reserve System during the first five months of 1977, 13 had deposits of more than $100 million. The five-month loss this year almost equalled the number of banks of such size that left the System in the preceding three years. Significantly, 9 of those 13 banks were located in New England. Indeed, almost one-fourth of membership withdrawals so far in 1977 have involved New England banks, a strikingly high share considering that as of the end of 1976 that region's members accounted for only 3% of total System membership. The influence of NOW accounts on the cost sensitivity of commercial banks is clearly visible in these statistics.

The growing awareness of the burden of Federal Reserve membership is dramatically reflected in data on bank deposits for our country. As of May 30 this year, member banks held an estimated 73 per cent of total deposits, down about 15 percentage points from the share held in 1950. In New England, the member-bank share of deposits fell from 75 per cent at the end of 1974 to 70 per cent at the end of 1976; and the erosion accelerated sharply in the first five months of 1977, so that at the end of May, the New England member banks held only about 63% of that region's commercial bank deposits.

The implications of these statistics are clear. The burden of membership has been causing banks to leave the Federal Reserve System at an accelerating rate, and the New England experience indicates that nationwide NOW accounts will probably accentuate the withdrawal trend. It is thus imperative that authority for extension of NOW accounts be combined with action to lighten the burden of Federal Reserve membership. S. 1664 would accomplish that by providing for the payment of interest on all required reserve balances held at Federal Reserve Banks. This is an essential part of the Administration's legislative proposal. Without it, as I have indicated, it would be impossible for the Board to support the proposal to extend NOW accounts nationwide.

The declining fraction of banks that are members of the Federal Reserve System is cause for concern on several counts. First, as the proportion of bank deposits at member banks declines, the links between bank reserves, on the one hand, and bank credit and the money supply, on the other, are loosened. This lessens the precision of the Federal Reserve's monetary control. The problem is complicated by the variability in the relative growth rates of member and nonmember demand deposits. Over the last decade about 45 per cent of the total rise in demand deposits has occurred at nonmember banks, but the proportion was as low as 23 per cent in 1967 and as high as 67 per cent in 1969. Swings of such magnitude add to uncertainty about the effects of open market operations on aggregate bank credit and deposits.

The membership problem complicates the exercise of the System's monetary control in still another way. At present, the Board's ability to vary reserve requirements in the course of conducting monetary policy is circumscribed by the fact that any increase in reserve requirements would tend to worsen the competitive disadvantage of member banks, and thereby prompt a further erosion of membership and perhaps also some more loosening of the ties between reserves and the monetary aggregates.

The nationwide NOW accounts proposed by S. 1664 would have the effect of further reducing the Federal Reserve's control over transactions balances if reserve requirements were not imposed on the NOW accounts at all depository institutions. That is why the legislation before you prescribes reserve requirements for NOW accounts at all depository institutions. This is an essential element of the legislative package. As the New England experience indicates, thrift institutions can be expected to capture a significant share of personal transactions balances nationwide, from both member and nonmember banks. Furthermore, if the attrition of membership is not arrested, a rising share of transactions balances at commercial banks will be in the form of NOW accounts at nonmember banks. NOW accounts, however, are an integral part of the money stock. In order to bring this portion of the money stock under the influence of monetary policy, it is clearly necessary that all NOW accounts be brought under the reserve requirement control of the central bank.

Aside from its implications for monetary control, the Board is deeply concerned about the structural weakening of the Nation's banking system that is being caused by membership attrition. Nonmember banks do not, of course, have ready access to the Federal Reserve discount window; they must rely instead on correspondent banks to meet their urgent credit needs. However, banking history demonstrates that correspondent banks cannot fulfill the function of lender of last resort in periods of strong over-all credit demands.

The decline in membership increases liquidity risk not just for individual institutions but for the banking system at large. This problem, moreover, is exacerbated by the fact that some of the banks that have withdrawn from membership have been on the weak side. For such institutions, cost cutting is understandably a pressing matter. But it is precisely those banks that can least afford to forfeit the insurance policy of ready access both to Federal Reserve counsel and to the discount window.

Remedial proposals for equal treatment of member and nonmember banks for reserve purposes are not new. In substance, the recommendation was embodied in a report of a Congressional committee chaired by Senator Douglas in 1950, repeated in 1952 in a report 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 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. Regrettably, however, such legislative proposals have evoked little interest in either branch of the Congress.

In view of apparent reluctance of the Congress to enact uniform reserve requirements for all banks, the Board has considered other proposals for ending the erosion of Federal Reserve membership. Our conclusion is that the payment of interest on required reserve balances is the most straightforward and appropriate step. Since the Federal Reserve returns virtually all its net earnings to the Treasury, payment of interest on required reserve balances would reduce Treasury revenues -- something, let me note with some emphasis, that would not occur if the Congress were to enact uniform reserve requirements. The net reduction in Treasury revenues would, of course, be considerably less than the total of interest payments to financial institutions, since part of the additional income of commercial banks and their stockholders would be recovered through the income tax. Staff estimates indicate that the Treasury would recover about 55 cents of each dollar paid in interest by the Federal Reserve to financial institutions.

Even though the cost to the Treasury would be only about 45 per cent of the payments made by the Federal Reserve, the Board is very mindful of the budgetary impact. If Congress enacts this legislation, I assure you that we intend to keep the net cost to the Treasury as low as possible. However, the Board will need sufficient flexibility to accomplish the purposes of the legislation. The bill before you limits the total payment that could be made to depository institutions in any given year to a maximum of 10 per cent of the previous year's net earnings of the Reserve Banks. At the present level of earnings, the indicated maximum could not exceed $600 million -- roughly equal to 2-1/4 per cent of required reserve balances. Given the host of prevailing uncertainties, the Board doubts that the proposed 10 per cent ceiling will prove adequate for coping with unavoidable cost problems of member banks. If present estimates are near the mark, overcoming the burden of membership will of itself require interest payments in the neighborhood of $500 million, so that there would be little room left for alleviating transition costs of NOW's or for introducing charges on Federal Reserve payments services. We are concerned, therefore, that the 10 per cent constraint may reduce System flexibility to a degree that will thwart the basic objectives of this legislation.

All the estimates of costs made by the Board's staff inevitably are subject to a substantial margin of error that should be allowed for in setting the ceiling that will govern interest payments on reserve balances. One simply cannot be sure, for example, what the transition costs of NOW's will be for banks. Nor can one rule out the possibility of either higher interest rates or higher reserve requirements in some year or years in the future. Either or both would increase the net burden of Federal Reserve membership.

In order to provide necessary flexibility, the Board urges that the maximum payment to depository institutions be set at 15 per cent of Reserve Bank earnings instead of the 10 per cent specified in S. 1664. The additional margin of 5 percentage points may never be utilized, but having the extra latitude is a necessary precaution. Over time, as the transitory costs of the NOW accounts subside and as the average reserve requirement declines as a result of the public's shift from higher reserve-ratio demand deposits to lower reserve-ratio NOW accounts, the size of interest payments on reserves is likely to decline below 10 per cent of System earnings. But for the years immediately ahead, flexibility above the 10 per cent level is needed.

In connection with the matter of making the Federal Reserve's payments services directly available to thrift institutions and nonmember banks, as authorized by the proposed legislation, I think it is important to indicate the

Board's present thinking and intentions. We believe that open access to the System's check collection services is desirable, providing a means can be devised for effectively equalizing the terms of access by all depository institutions. Equalization requires that all institutions bear the same level of costs for a given level of services. Member banks, in effect, already pay for payments services received through foregone income on reserves. The practicality of requiring equivalent balances from nonmembers is questionable in view of the apparent reluctance of Congress to enact a system of uniform reserve requirements. Thus, unless Congress moves in this direction, equalization presumably will have to be accomplished by means of a system of equitable charges and responsibilities applicable to all institutions.

The Board is considering -- and must consider more fully -- alternative systems for collecting charges for services, such as requiring clearings balances or fees from all depository institutions. The imposition of such charges, however, would have to make allowance for the fact that member banks are presently paying for the services they receive through income foregone. Such allowance is essential if we are to avoid reintroducing a burden of membership. Consequently, it will be necessary to offset charges for services to members by payments of interest on reserves.

Let me stress, however, that this additional interest will cause no net reduction in the amount of money turned over to the Treasury by the Federal Reserve. That is so because interest payments made to the members for this purpose would be equal in the aggregate to the amount of the charges imposed. As the bill is now written, the interest paid to offset charging for services would be included in the total of all interest payments on reserves and would thus use up a substantial part of the amount available under the 10% earnings ceiling. This very fact indicates in yet another way the desirability of a higher limit than 10%. Indeed, retention of the 10% ceiling could preclude adoption by the Federal Reserve of a pricing schedule for its payments services.

I must also advise this Committee that while the Board desires to move to open access, it will in fact be a difficult and time-consuming task to construct a system of equitable charges, in view of the diverse situations of the Nation's 15,000 banks and of the other depository institutions that will be affected.

Furthermore, since charges for Federal Reserve services will require significant adjustments at individual institutions, the Board considers it important to defer imposing charges until the transition to nationwide NOW accounts has been well accomplished. Until such time as it proves feasible to impose charges, the Board contemplates that as of the effective date of this legislation the System's check collection services will be made available to thrift institutions holding NOW reserves on terms comparable to those available to nonmember banks.

Before concluding this statement, I would like to comment briefly on one other area treated in the proposed legislation, namely, general reserve requirements. In addition to providing for the extension of reserve requirements at a uniform rate to all NOW and share draft accounts, this bill widens the band within which reserve requirements against demand deposits may be set. It also contemplates ending the anachronistic differentiation between Reserve City and country-member banks. The Board welcomes these changes, since they provide the Federal Reserve with an added measure of flexibility in the use of its authority over reserve requirements.

The Board seeks one amendment to the reserve requirement section of S. 1664. The statutory range from 3 to 10 per cent for time and savings deposits limits the Board's ability to modify reserve requirements in the interest of inducing member banks to lengthen the maturity of their time deposits. Although the Board has reduced reserve requirements on longer-term time deposits to as little as one per cent for maturities of four years or more, most member banks cannot take advantage of this provision since their average reserve requirement on time and savings deposits has reached the legal minimum of 3 per cent. Consequently, the Board wishes to have the lower boundary of the reserve requirement range on time and savings deposits reduced to one per cent.

That, Mr. Chairman, completes the Board's assessment of the major points of the proposed legislation. In closing, I would just like to restate the essentials of the Board's position. Interest is increasingly being paid on transactions balances, but the incidence of such payments is capricious -- determined by the accident of geography or by the financial sophistication of depositors. Congressional inaction will not stop the spread of interest payments on transactions balances; it will simply mean that the spread is to continue in haphazard, piecemeal fashion, attended by sundry inefficiencies and further distortion in competitive relationships among financial institutions. Official action to guide in an orderly manner the widening scope of interest payments on transactions balances is long overdue. The extension of NOW-account authority should not occur, however, without simultaneous action to eliminate the burden of Federal Reserve membership. That burden -- by inducing membership withdrawals -- is weakening the structure of our banking system. We should not risk a further weakening by legislating nationwide NOW-account authority without addressing the membership problem.

Most proposals for financial reform that have been considered in recent years have involved an unduly large number of complicated provisions which, in their entirety, presented formidable difficulties to proper evaluation. By contrast, S. 1664 addresses specific, pressing issues, and has quite limited objectives. The Board hopes that these features of the bill will enhance the prospect of early Congressional action.

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