BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

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ADDRESS OFFICIAL CORRESPONDENCE
TO THE BOARD

April 5, 1973

The Honorable William E. Simon
Deputy Secretary
Department of the Treasury
Washington, D. C. 20220

Dear Mr. Simon:

The Board has considered the implications of the seven legislative recommendations set forth in the Treasury memorandum dated March 19, 1973. This letter conveys the present thinking of the Board on those recommendations and related questions.

Before presenting the Board's positions on each of the issues raised in the Treasury's memorandum, some general principles that the Board considers of overriding importance should be emphasized.

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First, the Board continues to believe that universal reserve requirements for both demand deposits and NOW type accounts are necessary for purposes of both effective monetary policy and competitive equity. Presently, the higher reserve requirements imposed on Federal Reserve member banks, as compared to those imposed by the states on non-member banks, discriminate against member banks competitively and are resulting in withdrawals from membership in the Federal Reserve System. Should the percentage of bank deposits subject to Federal Reserve reserve requirements continue to decline, the Federal Reserve's ability to control monetary aggregates will be eroded.

The Board has long advocated equality of reserve requirements for member and non-member banks, and a succession of study groups has supported this principle. In 1961, the Commission on Money and Credit recommended that all insured commercial banks be required to join the Federal Reserve System. In 1963, the Committee on Financial Institutions recommended equal reserve requirements for demand deposits of member and non-member commercial banks. In 1971, the President's Commission on Financial Structure and Regulation (Hunt Commission) proposed that all institutions offering demand deposits be required to belong to the Federal Reserve System. This proposal was a crucial part of the Commission's program for equalizing regulatory burdens among banks and thrift institutions

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While the Board does not believe it is necessary to require System membership for all of these institutions, it considers it essential that all institutions should be subject to the same reserve requirements on demand and NOW type accounts.

More generally, the Board believes that wide-scale structural reform should pursue the objectives of basic equality of regulatory treatment for all financial institutions with similar powers, not only with respect to reserve requirements, but with respect to interest rate ceilings and taxation as well.

In addition, any changes that would serve to reduce materially the long-run supply of residential mortgage credit would be a matter of great concern to the Board and to the Congress as well.

Finally, any program aimed at restructuring the system of deposit intermediation must be carefully designed to preserve and enhance the soundness of banks and thrift institutions.

It is against the background of these principles that the following observations on the seven recommendations are offered.

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1. Elimination of Savings and Time Deposit Interest Ceilings (Regulation Q, etc.)

The Board supports the general goal of eventually eliminating interest rate ceilings on time and savings deposits, but only as the portfolios of thrift institutions have become sufficiently adjusted (see Issue 2) to permit them to compete effectively for funds even during periods of credit restraint. In addition, some discretion in the timing of the removal of interest ceilings is desirable, so as to minimize disruptive shifts of funds among institutions. In the case of NOW accounts, discussed under Issue 3, ceilings would be needed from the outset, albeit with the goal of gradual relaxation and eventual elimination. Therefore, the Board recommends a controlled phase-out of ceiling rates, rather than immediate removal at some specified date, and also recommends that a specific terminal date should not be set for the authority to regulate deposit rate ceilings. Termination of authority could be left to the discretion of the Board, or alternatively, the authority might lapse if not used over a specified period of time.

The Board also recommends that the conditions for imposing interest ceilings should be made more general. The proposal in the Treasury memo would not permit imposition of ceilings to protect the

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mortgage market or to prevent the threat of insolvency of financial institutions, for example, savings and loan associations. A preferable condition for imposition of ceilings would be when uncontrolled rates threaten to undermine the safety and soundness of depository institutions, or conflict with other public interest considerations.

The Board opposes the proposal for a five-agency committee to have discretionary authority to impose Regulation Q ceilings. Given the critical role these ceilings can play in the implementation of monetary policy, it would be desirable either to follow the Hunt Commission recommendations, which would place authority in the Board to set all deposit rate ceilings, or to leave the Board the powers it presently has to continue, suspend, modify or reimpose rate ceilings for member banks after consultation with the FDIC and the FHLBB.

2. Expanded Lending and Investment Powers

The Board generally supports the degree of asset diversification for mutual savings banks and savings and loan institutions contemplated in this recommendation. Broadening the lending powers of thrift institutions even to this degree, however, would raise some question as to the impact on the long-run supply of mortgage credit. This problem could be remedied by the proposed tax credit, but it is impossible to evaluate the proposal until the specific rate and other conditions of the tax credit are spelled out (Issue 7).

The Board believes that thrift institutions should be allowed to invest, to a limited degree, in mortgages that include some participation in income and/or capital gains. Such "equity participations" should be confined to mortgages on residential and related properties. The Board opposes the proposal to allow thrift institutions to invest directly in equity securities, although thrift institutions already making equity investments could justifiably be allowed to keep those investments.

The Board endorses the proposals to liberalize restrictions on real estate lending by commercial banks and to permit member banks to discount any class of assets at the Federal Reserve Banks at rates to be determined by the Federal Reserve. In addition, the Board recommends that commercial banks be permitted to make equity participation loans on residential and related properties to the same extent as thrift institutions. With respect to commercial bank underwriting of "certain revenue bonds," the Board would like to reserve comment until the details of this proposal are made more specific.

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3. Deposits and Third-Party Transfer Systems and Reserves

The Board believes that NOW account privileges should be extended to all depository institutions, but that the class of depositor eligible to hold such accounts should be confined to households. It also believes that NOW accounts offered by all institutions should be subject to identical interest ceilings, established by the Federal Reserve, FDIC, and FHLBB in consultation with one another; that NOW account deposits of all institutions should be subject to identical reserve requirements set by the Federal Reserve; and that reserves should be held in cash or in deposits at the Federal Reserve.

The Board agrees with the proposal concerning demand deposits except as it relates to reserve requirements. While the Board does not propose required membership in the Federal Reserve, demand deposits of all institutions should be subject to identical reserve requirements established by the Federal Reserve, with such reserves to be held in cash or in deposits at the Federal Reserve.

The Board endorses broadened authority for it to set reserve requirements for demand deposits between some minimal figure, such as 5 per cent, and 22 per cent. The Board opposes the phasing out of reserve requirements on commercial bank savings and time deposits, since such required reserves are a potentially useful weapon for combatting excessive increases in commercial bank credit. The Board would endorse a broadened authority to set reserve requirements on time and savings deposits between some minimal amount, such as 1 or 2 per cent, and 10 per cent. The Board believes that reserve requirements for NOW accounts should be set somewhere between the requirements for demand deposits and those for savings accounts.

With respect to all of the foregoing categories of reserve requirements, the Board should have flexible authority to establish structures of differing reserve requirements within the indicated percentage limits, as is provided by present law.

The Board is opposed to permitting government securities to be used to fulfill part of total reserve requirements, since this confuses the role Treasury securities play in providing bank liquidity and the function of reserve requirements in monetary management. Furthermore, this provision could open the door to efforts to finance Federal outlays by mandated bank purchases of government debt.

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4. Charters for Thrift Institutions

The Board endorses the proposals contained in the Treasury memorandum.

5. Credit Unions

The Board concurs, in general, with the proposals for credit unions set forth in the Treasury memorandum.

6. The FHA Interest Ceiling Will be Removed

The Board endorses this proposal, and assumes that it is meant to include interest rate ceilings on VA-guaranteed mortgage loans.

7. Taxes

The Board endorses the proposal for equal tax treatment with respect to additions to loan loss reserves.

The Board is not opposed to a tax credit on mortgage interest income. However, before it could endorse the proposal, the Board would need to know the details of the recommendation, including the size of the tax credit, applicability to GNMA mortgage-backed bonds, applicability to non-residential mortgages, and its likely distribution among various classes of individual and institutional investors. The Board would like to point out that one limitation of such a tax credit is that it would have no value to investors with no tax liabilities, including pension funds.

In the interest of brevity, this letter has not developed at length the reasoning and analysis that underlies its conclusions. If you would like to explore these matters further, we suggest that you or someone on your staff contact Mr. Sam Chase of the Board's staff.

Sincerely yours,

(signed) Tynan Smith

Tynan Smith
Secretary of the Board

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