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NEWS RELEASE

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H. R. 1901, Regulation Q, NOW Accounts, and Payment of Interest on Demand Deposits

Address by

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before the

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of the
New York State Bankers Association

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Regulation Q and our companion Regulation 329 will effectively expire on March 1, 1977 unless its termination date is extended by Congress. A bill, H. R. 1901, has already been introduced in both the House and the Senate, co-sponsored by the Chairmen of the respective Banking Committees and the Subcommittees having jurisdiction over financial institutions, to extend for 90 days the life of Regulation Q. Hearings will be held on that bill in the House within the next week.

In addition to extending Regulation Q for 90 days, the bill will also grant the authority for federally chartered institutions to issue interest-bearing NOW accounts in the States of New York, New Jersey and Pennsylvania. As you know, that authority already exists and is being utilized in all of the New England states. Finally, the bill will extend additional powers to credit unions, including the authority to make 30-year mortgages, and will extend the authority of the U. S. Treasury to borrow from the Federal Reserve System.

The FDIC position on the bill will be one of no objection. We will not, however, take a position of no comment, since to reach a position of no objection to the bill requires some considerable analysis on our part. It seems appropriate to me to discuss this analysis before New York State bankers since New York and the New England states have been so innovative in banking law changes recently and since you would be directly affected by the bill.

Allow me to review for a moment the competitive structure and regulatory climate for competition between depository institutions in New

York State. That banking structure has not changed substantially during the first half of the 1970s in terms of the number of institutions, offices, and deposit distribution among the three types of institutions, i. e., commercial and mutual savings banks and savings and loan associations. Commercial banks presently account for roughly the same number of institutions and three times the number of offices as thrift institutions. The only major deposit category in which the commercial banks do not dominate is in the market for personal savings and time deposits. While commercial banks hold about two-thirds of all funds in depository institutions, they account for only about 16 percent of personal savings and time deposits, about the same as in 1970. Clearly there has not been a substantial upheaval in the competitive structure in New York during that first half of this decade.

However, there have been significant changes in the regulatory environment during this time. Principal among these changes were the move to permit statewide branching, the establishment of off-premise EFT machines and, most recently, the granting to mutual savings banks and state-chartered savings and loan associations the authority to offer personal checking account and overdraft privileges. While these changes are significant, they are not the only changes that will take place. Besides those included in the bill I have referred to, a host of other financial measures will probably be under Congressional review sometime this year. These include Federal branching policy, payment of interest on demand deposits, and broader asset and deposit powers for thrift institutions.

Each of these topics warrants serious and extended consideration. I want to focus today on those that will be receiving the most immediate concern by the Congress -- extension of Regulation Q and expansion of NOW accounts. Both of these cover a number of related and interconnected issues. The former means consideration of the differential and treatment of IRA and Keogh accounts. The latter, of course, raises the question of further expansion of NOW accounts, the whole issue of interest on demand deposits and in some states, though not New York, the issue of entry of thrift institutions into the payments business.

Restrictions on the interest rates that can be paid on time deposits, and prohibition of payment of interest on demand deposits, have been part of the American banking system since the major banking reform legislation of 1933 and 1935. The origin of these restrictions is somewhat more complex and confused than generally believed, and so I want to spend a few moments reviewing that history.

The conventional wisdom is simply that interest rate restrictions were adopted in response to, and as a solution to, our bank failure experience of the 1920s and early 1930s. In that view, banks were competing excessively on a rate basis, bidding deposit interest rates up to levels that forced banks to acquire riskier assets in order to meet their interest obligations. Further, it is argued, high rates on demand deposits, particularly on correspondent balances, were a means by which funds were attracted to the financial center banks from the rural and agricultural areas of the country. These funds were then lent out with stocks as collateral and fed the flames of stock market speculation during the late 1920s.

This is a neat theory, tying together, as it does, a number of events of the 1920s and 1930s -- agricultural depression, bank failures, stock market speculation and eventual financial collapse. It also accords with the personal experiences and recollections of a number of bankers who lived through this period. The only problem with this interpretation of history is that it probably never happened, or at least not quite like that. Over the last 10 to 20 years, there have been a number of scholarly studies of the experiences of the 1920s and 1930s. The evidence these scholars have reviewed does not support the view that banks engaged in widespread excessive competition to attract deposits which then had to be invested in risky assets. The evidence, in fact, suggests that deposit interest rates tended to <u>decline</u> during the 1920s. And the casual relationships appear reversed. New York banks had the opportunity to make high-yielding loans on perfect security -- stock market collateral. This led them to pay rates on correspondent accounts that attracted the deposits they needed. That does not mean, of course, that there were <u>no</u> instances of banks striving for growth by paying excessive interest on deposits. After all, in the early 1920s, we had over 30,000 banks in the U.S., many of them in small communities newly accessible to the big city (and big city competition) by the development of the automobile. Some followed irresponsible policies in this environment.

Why then did Congress impose restrictions on interest on deposits? One answer may be that data which seems clear to historians now was not so clear to them or anyone else, including Congress, in the early '30s. In addition, Congress in the 1920s had the same problem as Congress has today of making trade-offs among conflicting interests. There was strong support in the country for a Federal deposit insurance program. But bank profits were inadequate to finance such a program. A number of economic historians have concluded, although the basis for this seems to be indirect rather than direct evidence, that a deal was struck involving deposit insurance (increasing expense and opposed by large banks) and prohibition of interest on demand deposits (decreasing expense and supported by large banks).

A ceiling rate on time deposits was included in various versions of the Banking Act of 1933. It was intended to prevent excessive competition for such deposits that could endanger bank solvency, but received little attention in Congressional debate. In the earlier versions of the legislation, a fixed ceiling (4 percent in one version, 3 percent in another) was set as an upper limit on rates. Even the 2 1/2 percent figure set by the Federal Reserve under the Act as passed was well above what banks were paying.

Thus while the demand deposit interest ban had an immediate impact on banking, by the time Regulation Q became part of the regulatory structure, it did not have any substantive importance. For many years the time deposit ceiling was above market interest rates. The maximum rate payable on time deposits of all types remained at the 2 1/2 percent level until raised to 3 percent in 1957.

Whatever may have been the reasons initially for establishing Regulation Q ceilings, it is clear that the major reason for Regulation Q is no longer concern about commercial banks competing with commercial banks and the soundness of the banking system. It is rather the problem of protecting thrift institutions from commercial bank competition. Actually, of course, the concern expressed may not be for the thrift institutions, although the concept of mutual ownership rather than stock ownership may be more appealing to some critics, but rather for the single-family housing market. Thrift institutions are the largest providers of financing for single-family homes. Some argue that if they could not attract deposits, the housing market would suffer from a shortage of funds.

It seems clear, then, that any reasonable analysis of Regulation Q, including the differential, must address itself at least in part to the question of housing. Why is housing such a politically sensitive issue? I do not know the real answer to that, but it lies deep in our traditions and folklore. The American public has accepted as a social goal the concept of individual home ownership. The typical American is working toward that objective of a single-family house, surrounded by a plot of grass and a white-picket fence, whether he is in Nebraska or New York. In the early post World War II years, housing in the United States was cheap relative to incomes because of low interest rates, improved transportation, cheap energy, some innovation in building techniques and a failure to factor in all social costs. This relationship was out of line with historical housing costs and what we have experienced more recently -- yet our policies not surprisingly seem to be designed to bring back this "ideal."

There are problems associated with placing this high a value on home ownership. Among other things, it has contributed to suburban sprawl, excessive energy consumption, and decay of the downtown areas of many of our cities. Despite these problems, however, housing is, in effect, treated as a sacred cow by the Congress. Virtually any major piece of financial legislation has to be discussed in terms of its effect on housing.

Housing, for example, seems clearly to be the rationale for the quarter-point differential in maximum rates that can be paid by thrift institutions as compared with commercial banks. The contribution of the thrift industry to housing has been clearly demonstrated. Commercial bankers, on the other hand, have failed to get across to the public and to the Congress their very real contributions to housing construction. Commercial banks, for example, hold about one-fifth of home mortgages in the U. S. and provide the bulk of the financing of the development costs of multi-family housing units, housing subdivisions, shopping centers, etc. Their importance to housing, I suggest has not been properly explained.

There are a number of issues that surface when indirect methods which work through effects on interest rates paid are accepted as the solution to the problem of building sufficient housing -- issues such as equity and efficiency. But the most serious difficulty with the Regulation Q approach is simply that it doesn't always work. Regulation Q can protect thrift institutions from commercial bank competition. But it cannot protect them or smaller commercial banks from competition from the unregulated market. In 1966, again in 1969 and several times in the 1970s, the advent of high interest rates led depositors to opt out of our system of financial intermediaries and to invest their funds directly in market instruments. This process is essentially an inefficient one. Banks and financial institutions provide a useful economic function in amassing the deposits of the public and lending or investing the funds where the demand is greatest. That economic efficiency is lost when financial institutions' role is diminished or short-circuited.

During the early periods of disintermediation the public moved to Treasury bills and other government securities, slowly at first, and more rapidly as more and more people learned about alternatives to depository institutions. Of course once interest rates came down again they returned to the financial institutions, but they did not forget what they had learned. As interest rates in the open market have risen above Regulation Q ceilings, depositors have jumped back to the market more quickly each succeeding time.

Several hurdles have been developed so that it has become more difficult for the small investor to jump into the open market -- the minimum denomination on Treasury bills has been raised, commercial banks have been prevented or discouraged from selling subordinated notes or commercial paper to customers, etc. By 1970 it was clear that anyone with over $100,000, however, could not be compelled to keep his funds in an institution that was not allowed to pay the going rate for money, and the banking agencies made that official by removing Regulation Q ceilings on all deposits over $100,000.

Investment in open market instruments became much easier for the small depositor with the development of the money market mutual funds in 1973. These funds, investing in bank CD's, commercial paper or government securities grew to a $3 billion industry in almost no time at all. More important, they have not shrunk significantly during the periods of low interest rates. No one can doubt that these funds will receive a huge inflow of funds when and if open market interest rates again exceed Regulation Q ceilings.

It is important to note that the money market mutual funds pose a competitive threat to the thrift institutions and to the smaller commercial banks, but probably do not pose such a threat to the large commercial banks. The money market funds use most of the money they receive to purchase CD's of the largest banks. Thus the funds flow out of the smaller institutions and into the largest -- not because the largest are more efficient or sounder, but because they are big. I am sure that there are some bankers here who think that is a great arrangement, but I suspect you are in a minority.

As I have indicated, extension of an effective Regulation Q comes up for Congressional consideration very soon. At the present time, Regulation Q ceilings are irrelevant in that going rates are at or below the ceilings. That is, if ceilings were removed, very few institutions would consider increasing their rates. But this situation will probably not last forever. Hence the debate over extension of Regulation Q authority will be intense.

Numerous analyses of this matter have been made in the past by various distinguished Commissions and Committees, all of the recent ones of which concluded, with various qualifications, that interest rate ceilings should eventually be eliminated. The position of the financial institutions involved, however, is not so clear cut.

Virtually all thrift institutions want a continuation of interest rate ceilings and, in particular, continuation of the mandatory differential in their favor. Some few of them would be willing to give up the differential if they could get something else they do not now have as part of the package. That might include Federal chartering of mutual savings banks, checking account powers, instalment loan powers, or some new tax break. If they got such additional powers, they would then be willing to see a phasing-out of Regulation Q or the elimination of the differential at some time in the future, a time which incidentally never seems susceptible of precise definition.

The commercial banker position is more complicated. Many banks, most of them large, favor elimination of Regulation Q completely. Virtually all commercial bankers favor elimination of the differential, though some favor it only if it is done by reducing thrift institution ceiling rates rather than by increasing commercial bank rates. And all bankers put particular emphasis on the inequity (both to banks and to their customers) of the differential on IRA and Keogh accounts. On these long-term deposits of fairly large size a 25 basis point advantage becomes enormously significant over a 20 or 30 year period.

When all is said about the differential, however, it seems to me that the majority of small commercial bankers favor continuation of Regulation Q. There is much to be said for that position from the point of view of bank profits. The evidence does indicate that bank earnings are better in periods in which interest ceilings are effective. That is not too surprising. Many industries would be better off, at least in the short run, if there were a legal limit on the price they could pay for their raw materials (which is, after all, what deposits are to the banking industry).

In our political and economic system it is perfectly proper and appropriate for a business firm, an individual or an industry to support legislation that benefits them. Such efforts are not likely to be successful, in the longer run, however, unless there is some perceived public interest aspect to their legislative objective. Concern over housing has been enough in the past to support the differential in rates and the arbitrary ceilings on amounts small savers can earn. It may be, however, that this will not always be sufficient. Let us look, therefore, at the fears and concerns that smaller commercial banks have about operating in a world without interest rate ceilings.

First of all, many commercial bankers make the perfectly valid point that free competition on the deposit side is unfair when they are subject to usury ceilings on the asset side. New York is one of the many states that has restrictive ceilings. Usury ceilings serve no useful purpose (except to assure ample demand for the services of loan sharks). It has never ceased to amaze me how timid bankers are about confronting the public and their state legislatures with the inequity caused by usury ceilings. The FDIC has seen examples, in fact, of some state usury ceilings making it extremely difficult for even the best managed banks to stay profitable during difficult economic periods such as the ones we've just gone through.

A second fear is that without interest ceilings the large banks would be able to afford higher rates and would grow at the expense of the smaller banks. There is only little, if any, evidence to support this. Several studies, including some done at the FDIC and some done by the New York State Banking Department, have found that while large banks have some cost advantages over small banks, these are generally not overwhelming and should not, by themselves, make small banks non-competitive. In fact, many observers believe that many bank customers have a preference for doing business with the small, local bank rather than with a giant institution.

The most prevalent concern that I find in discussing this matter with commercial bankers is the fear that without interest rate ceilings their competitor down the street (not themselves) would be stupid enough to seek to grow rapidly by paying absurdly high rates on deposits. In order to retain deposits, they would have to follow with equally ridiculous increases. They argue that this happened during the 1920s. I have already indicated that most serious historians have concluded that this did not in fact appear to have happened to any significant extent during the 1920s. But saying this doesn't by itself remove the fears.

I have a great deal of confidence in the intelligence and business sense of American bankers. I simply don't believe that very many of them would act against their best interests by paying rates that are unprofitable if Regulation Q ceilings are removed. Clearly, however, out of 14,500 banks, some will be managed by very foolish managers. Last month the FDIC was called in to assist in connection with the failure of a $160 million deposit bank in New Orleans -- International City Bank. The problem that led to that bank's failure can be traced, in part, to its actions during the summer of 1973. During that period the government agencies experimented with an elimination of interest rate ceilings on 4-year small denomination CD's. When International City Bank closed, about one-third of its deposits consisted of CD's paying interest at 9 percent. This shows what can result in the free market when managers act unwisely -- the bank fails. The other banks in its market, however, did not feel constrained to follow the lead of International City Bank. They did not raise their rates as ICB did. And, incidentally, when ICB failed, the FDIC was able to arrange a purchase and assumption transaction which dramatically minimized the impact of that failure in its market. Finally, after reviewing the position of other banks in the country, we have found no others in anything like that position as a result of our limited free market experience.

If small banks could survive without interest ceilings, what about thrift institutions? I am rather optimistic about their ability to compete although I recognize that mine may be a minority view. First of all, we must bear in mind -- and this applies to commercial banks as well --

Regulation Q provides no protection against the market. If interest rates rise to very high levels again, the means by which funds can flow out of depository intermediaries are now in place, and consumer awareness of them now exists, so that disintermediation would probably take place on a much more massive scale than ever before.

If we do not have record levels of interest rates, thrift institutions can compete very successfully. Every month they are getting rid of some of the low-yielding mortgage loans made years ago that have been holding down their earnings. Mortgage demand is good and rates are staying firm. The cost of deposits is now falling, thus affording them a comfortable spread. It may not be fair to say that thrift institutions never had it so good, but they are in a position to compete even if interest rates rise significantly.

Their ability to compete would be further enhanced, even in periods of very high interest rates, if steps were taken to improve the mortgage instrument that is their major asset holding. Wider use of the Variable Rate Mortgage, perhaps combined with the authority to issue variable rate deposits, might be desirable. Tax benefits or direct subsidies for mortgages should be considered if housing remains the important social goal that it is.

Those last comments on the ability of institutions to compete without controls leads us to the more basic question: What is gained by elimination of rate ceilings? The major benefits are those results usually associated with a free enterprise, competitive system -- in the economist's jargon, efficiency in the allocation of resources. That is, resources flow to where they can earn the highest return. Small savers as well as large would get a return commensurate with what a user of those funds is willing to pay. Of course, this may mean that borrowers, in periods of tight money, will have to pay higher rates than they would in a world of deposit rate ceilings. But isn't that equitable? Why should the small saver subsidize the homeowner?

Banks now compete by giving away dishes and transistor radios to attract deposits from people, some of whom probably would rather have money. And we find banks wastefully competing for deposits by putting branches on every corner -- forced to compete on the basis of convenience because the law does not allow them to compete on a rate basis. Of course, I have nothing against convenience, nor anything against dishes and transistor radios. The point is that in a free market the bank could choose to compete on the basis of gifts, convenience, or, through saving on the costs of premiums or branches, on the basis of rate. The customer to whom rate is most important would make his choice on that basis. The customer concerned with convenience would opt for a different bank.

This more efficient world which I've described might well be a less profitable world for bankers and a riskier world for bankers. Let me emphasize that risk. Many academic critics of Regulation Q have been unwilling to admit that among 14,500 banks some of the bankers will respond to the challenge of a free market in an overly aggressive manner. Well, I believe some will. And some will make serious mistakes in their aggressiveness, so serious that the bank they manage will fail. I can only note that it is the poor banker who will fail, not the sound. In New Orleans it was the bank that sought very rapid growth that failed -- not its competitors. I believe that the FDIC has the capability to deal with a situation in which the number of bank failures increases nominally above present levels. Thus the failure of a few banks, which in our judgment is all we're talking about, need not spread or cause concern about the health and stability of the banking system.

What is the long-run fate of Regulation Q? I agree with a statement by ABA ex-president Rex Duwe that "if Regulation Q is phased out, it won't be because banks want it or because they don't want it, or because thrifts want it or don't want it. It will be because consumers want it." At the present time, I cannot judge whether the bank customer sees the removal of Regulation Q ceilings as an advantage or a disadvantage, so I cannot judge what Congress feels about the issue.

Perhaps I have spent too much time on Regulation Q. Interest rate regulation on time deposits is, after all, not the most important Federal restriction on interest rates. In a series of meetings with bankers held around the country by the FDIC, we have found that the single most frequently raised issue is interest on demand deposits. On this topic, as distinct from the diversity of views on Regulation Q, bankers are almost universally united -- all in opposition to being allowed to pay interest on demand deposits. They raise the same competitive concerns as with Q, but some add the very important point that the cost of even a modest rate of interest on demand deposits would exceed their total profits. I happen to believe most of those bankers who give me those examples.

I would like to suggest, however, with respect to interest on demand deposits, many bankers are already paying it. Remember that along with demand deposit accounts go extensive and expensive payment services and a payments system. Large corporate customers know the value of their account to you and of your services to them. They will keep their account at a size sufficient to compensate you for the services provided and not much more. Even where such large corporate clients are not the mainstay of a bank's earnings stream, it is also true that the cost of providing checking account services to small business or household accounts often exceeds service charge income. I suspect that it would not be just coincidental if that excess is quite close to an amount equal to a reasonable rate of interest.

It has long been part of American banking tradition to use balances as a means of paying for services. That tradition has been changing, however, and the pace of change has accelerated in recent years. Demand deposits now comprise less than 40 percent of all commercial bank deposits, compared with 50 percent ten years ago and 73 percent twenty years ago. This, as well as several other developments, is tending to break down the distinction between time and demand deposits.

A few years ago the banking agencies allowed telephone transfers from savings accounts to checking accounts and many banks started providing such services. Some thrift institutions will make transfers to third parties on the basis of a telephone call. Of course, certain pre-authorized third party payments out of savings accounts are also permitted.

Last year the agencies proposed, but didn't adopt, a regulation that would have allowed automatic transfers from savings accounts to checking accounts to meet overdrafts. The difference between that and interest on demand deposits is extremely subtle.

Last year corporations were allowed to hold savings accounts. Corporate treasurers, even of the smaller companies that were attracted to savings accounts, have every incentive and sufficient knowledge to move funds from savings to checking accounts and vice versa so as to minimize holdings of idle balances and maximize interest earnings.

A more significant innovation, of course, has been the introduction of NOW accounts in New England. While all the results of the NOW account experiment are not in, there are a few points where the evidence is clear: NOW accounts do represent in fact interest on demand deposits; NOW accounts have been very popular with the public; they have had an adverse impact on bank profits (which has become greater as interest rates on loans have come down); NOW accounts have become a means by which savings institutions have entered the checking account business. One further indication from the New England experiment with NOWs has, in my view, very important implications for interest on demand deposits. As NOW accounts became widely available in Massachusetts, most were offered on the basis of 5 percent interest (the legal ceiling) and free service charges. In recent months, however, the trend has been away from free accounts and toward imposing a charge for checks written.

The movement of savings institutions into the payment services business has already had significant impact on competition in those states where it has taken place. This impact has varied from state to state. In Massachusetts, the savings banks now have a substantial share of the household checking account business. In New York, the impact of savings bank entry into this business has been varied. Some mutual savings banks have competed vigorously for checking account business, while others have not, perhaps because of the limitation of the New York law prohibiting service charges on such accounts.

A recent survey by the Federal Reserve Bank of New York has found that thrift institutions in New York State have made significant inroads into the household checking account business during the few months in which they have offered checking accounts. They estimate that thrift institutions now account for about 10 percent of the number of household checking accounts in the state, and about 3 1/2 percent of the dollar amount. The impact of this competition appears to have been greatest in the upstate areas. Commercial banks in the Albany, Buffalo and Rochester areas have had an absolute drop in the number of household checking accounts since the thrift institutions have entered this business.

The early experience with thrift institution checking accounts suggests that one-stop banking is a very important factor in people's decisions regarding the selection of banks in New York. Many commercial banks that experienced a drop in their number of checking accounts also had a drop in the number of their savings accounts. That suggests, although the evidence in the survey is not definitive, that once the New York public has the opportunity to do its one-stop banking at a thrift institution, the 1/4 point differential is a powerful attraction. The New York Fed survey also found that thrift institutions not offering checking accounts experienced a drop in the number of their savings accounts. That is, the public attracted by the advantage of one-stop banking, selected those thrift institutions where they can have both a checking account and a savings account. Offering checking accounts appears to be an important tool in competing for savings accounts.

The extension of NOW account authority in New York, Pennsylvania and New Jersey that is in the bill currently before the Congress is viewed by some as a minor adjustment designed to provide a means for Federal S&L's to compete in the checking account business with the mutual savings banks and the state chartered S&L's which already have such powers in those states. But I view it as a more significant measure. The introduction of interest-bearing NOW accounts in these three major commercial states will put pressure on other major commercial states to adopt similar legislation for the benefit of the banking public in those states. The logical movement to a widespread, although not necessarily nationwide, use of NOW accounts is then obvious, if it was not already obvious from the consumers' acceptance of that deposit in New England. Some New York mutuals that have not been aggressive in seeking checking accounts may actively seek NOW account business, viewing it as a more attractive approach to the payments business than free checking accounts.

For mutual savings banks, NOW accounts are a means of gaining new deposits, and these new deposits are acquired at the 5 percent rate rather than the 5 1/4 percent passbook rate that most of them are now paying. Even if the NOW accounts they obtain are just a switch of existing accounts, that is not too costly for mutual savings banks. They are at least saving 1/4 percent in interest costs.

For the commercial banks, the situation is somewhat different. The New England experience demonstrates rather clearly that they can attract NOW accounts. The commercial banks, not the mutuals, have been gaining the bulk of NOW accounts for the last year. The NOW account is not only a good substitute for a checking account, it is also a good substitute for a savings account, and commercial banks can compete for that business on an equal basis in terms of rate with the mutual savings banks. But many of the new NOW accounts recorded by the commercial banks in New England represent simply a switch of existing household demand deposits, and they represent an expensive switch, requiring a 5 percent payment as compared with a zero payment.

The expansion of thrift institutions into the payments business, and the payment of interest on checking accounts are two important aspects of the NOW account. Both of these are linked to EFTS.

In the long run, though not necessarily right now, EFT systems will prove cheaper than the paper check payment system. Two aspects of this potential cost advantage for electronic systems have not received adequate attention. First, as savings institutions get into the payments business in the future, it is quite possible that they will be getting in on an electronic basis. They may leapfrog over the technology now used by commercial banks and avoid the costs of the check clearing system that commercial banks are now bearing.

Second, it will be difficult to get the public to use EFTS because, under our present system, customers do not pay the full costs of the check payment system. If I am using a payment system that I am accustomed to, and which is essentially cost-free to me, why should I be interested in a new and different system that may be cheaper for the banker but in some ways less convenient for me? I suggest that EFT systems may prove more marketable if we have moved to a system involving interest on checking accounts and explicit charges for services provided.

Quite understandably, many bankers view the prospect of paying interest on demand deposits as somewhat akin to a major disaster. Far be it from me to minimize the danger to certain banks. While no one can predict with any precision just how these things will work themselves out, it is likely that over the long run the banking system as a whole can adjust to explicit interest payments on demand deposits as it has adjusted to implicit interest payments on demand deposits in the past.

I recognize, however, that in the long run we are all dead. For most of us it is the short run which occupies the position of immediate importance. Without careful planning, both by banks and by government, the payment of interest on demand deposits could be quite troublesome for individual banks. Those small banks with high demand deposit percentages in their balance sheets and with little local opportunity to enhance earnings following introduction of interest on demand deposits would have considerable difficulty. The same will be true of banks with unusually high balances from correspondent banks. It will not satisfy any of these bankers to say that the banking system will be able to adjust over time. They know they will have serious difficulties over the short run.

On the other hand, continued prohibition of demand deposit interest cannot be viewed with equanimity by bankers, even by the very banks which would have problems if interest were permitted on those deposits. The relative shrinkage of demand deposits which has gone for many years is likely to continue, especially if interest rates remain high on average. This imposes costs for the banking system in the form of higher interest payments on time deposits and a diversion of deposits to competitive institutions and instruments. In the final analysis, then, demand deposit costs will increase regardless of what happens to the zero interest ceiling, and without some of the benefits (such as increased use of the less costly EFT systems) that might otherwise flow both to the bankers and to the public.

It seems to me that now is the time for banks to intensify their studies on what improvements could be introduced to cushion new costs in this area. Can service charges be increased to meet the new situation? Should reserve requirements be reduced and should permission be given to hold these reserves in earning assets? Should the agencies be conducting research into pricing structures for services, and should bank examiners be trained to be helpful to bankers in discussions on pricing of services? What other way can costs be controlled or income increased?

Interest on demand deposits, if it comes, is not going to come overnight. The banking industry can use this period wisely or it can use all of its resources and energy in attempting to prevent it. The latter course of action could lead many individual banks to forego or postpone the opportunity to plan for a change which in many respects is already here for more and more banks.

As I mentioned at the beginning of this speech, the FDIC will raise no objection to the passage of H. R. 1901. While the analysis of its implications have comprised the bulk of this speech, the fact is that we do not feel that its passage or the long-range results which might follow its passage would cause chaos in the banking system. We feel that the experience in Massachusetts, New Hampshire and the rest of New England with NOW accounts is good evidence the Corporation, with the assistance of the other federal and state regulatory agencies, would be able to deal with the few individual bank problems which might flow from these changes.

We think it is essential, however, that should Congress approve the expansion of NOW accounts both Congress and the industry recognize the possibility that some individual banks might encounter serious trouble as a result of these changes, and that a few of them might fail. Even if this is so, we believe that the tools which the Corporation has available to it and which the Corporation has demonstrated an ability to use during the last few years are sufficient to prevent any significant or widespread failure of confidence in the banking system.