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Statement on
Nationwide NOW Accounts, Interest on Reserves
and Related Issues,
Re: S. 1664, S. 1665, S. 1666, S. 1667, S. 1668 and S. 1669.

Presented to the
Subcommittee on Financial Institutions of the
Senate Committee on Banking, Housing and Urban Affairs..

United States Senate

by

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Chairman, Federal Deposit Insurance Corporation

June 20, 1977.

Mr. Chairman, I welcome this opportunity to testify with respect to six bills dealing with financial institution reform -- S. 1664, S. 1665, S. 1666, S. 1667, S. 1668 and S. 1669.

Because of the magnitude and complexity of the legislation before us, we have attempted to deal with those points which are of major significance, those which directly affect the FDIC, and those in which the FDIC has special expertise. I should emphasize that we at the FDIC stand ready to assist you and your staff in whatever fashion you deem appropriate as you wrestle with the difficult issues raised by the legislation before you. Moreover, we would hope from time to time to provide you with further comments as our analysis proceeds.

Before turning to the specific legislation, I should like to touch briefly on the matter of financial institution reform generally because my specific comments do flow directly from certain basic principles. As you know, I supported the recommendations of the Hunt Commission and the goals embodied in the Financial Institutions Act. I was heartened when the Financial Institutions Act of 1975 was passed by the Senate and disappointed at its subsequent demise in the House. It continues to be my view that more direct competition among financial intermediaries and greater reliance on the direct operation of a free market, rather than on a system of controls and restrictions, is a more efficient and effective way to allocate deposit funds. Moreover, I believe that the Hunt Commission was essentially correct in its strong recommendations that financial restructuring should not be accomplished piecemeal but rather in the context of a comprehensive legislative package designed to provide as equitably as possible for transition to the new structure.

Nevertheless, events have shown that supporters of comprehensive financial reform were perhaps a bit naive. It is indeed time, as you suggest, Mr. Chairman, "to engage in the art of the possible; to promote those measures which are in the public interest and which are capable of being enacted." Accordingly, it seems to me that we should work to identify sub-packages within the framework of financial institution reform which constitute constructive and progressive steps and which are politically viable. The legislation before us represents an attempt to do just that.

At the outset, I would like to interject one note of caution. Since the recommendations of the Hunt Commission in 1971, developments in the marketplace and at the state level have taken us far along toward the goals that the Hunt Commission envisioned. Competition among financial institutions has increased and innovative strategies such as the use of the telephone and electronic transfers and money market funds have undercut the effectiveness of rate ceilings and restrictions, leading to an increasing reliance on the pricing mechanism. In this light, it seems to me that we must take special care that, in balancing all the affected interests, we do not create a regulatory framework which is apparently progressive but which in the long run serves to impede innovation and stifle competition. Restrictions and regulatory mechanisms intended to be temporary often become permanent. This tendency ought to be carefully guarded against in the context of our frustration with the failure of financial reform in the past.

Rather than attempting to deal with all of the issues before us today, I shall focus on five issues: (1) the extension of NOW and share draft account authority provided in S. 1664 and S. 1668; (2) the provisions of S. 1664 and S. 1668 dealing with the problem of attrition of membership from the Federal Reserve System and the relationship of nonmember institutions to the Federal Reserve System; (3) the extension of the agencies' authority to set interest rates dealt with in S. 1664, S. 1666 and S. 1668; (4) the provision of a Federal chartering option for mutual savings banks in S. 1665 and S. 1666; and (5) the extensions of Federal deposit insurance coverage provided in S. 1666.

I. NOW and Share Draft Account Authority

For my own part, I have long supported elimination of the prohibition of interest payments on all transactions balances. Economists have demonstrated that there is no merit to the contention that competition for demand deposits through the payment of interest led to bank failures during the Depression as some contend. Economists have demonstrated, at least to my satisfaction, that competition for deposits through the pricing mechanism would result in a more efficient allocation of resources than competition through indirect means involving the implicit payment of interest by building more branches, keeping open longer hours, providing free checking services, offering premiums and free traveler's checks, as well as a variety of other services. Such competition would also be likely to result in substantial benefits for both financial institutions and bank customers.

The benefits are several. Free or below-actual-cost checking encourages inefficient use of resources because depositors have no incentive to economize on check writing, even though check clearance costs are substantial. Direct charges for checks would prompt depositors to write fewer checks and these fees should cover a substantial cost of clearing checks. Explicit pricing of bank services so that each service produces a profit on its own will enhance a financial institution's capability of paying a competitive interest rate on deposit balances without impairing earnings.

Such explicit pricing for checking services will also conserve bank resources by reducing the volume of checks, and payment of competitive interest rates will lower some operating costs by reducing the need to transfer funds between transactions accounts and other interest bearing accounts. This will benefit customers because they will need to spend less time and effort in managing deposit balances, particularly when interest rates are high. Finally, existing inequities, whereby some depositors subsidize the expense of servicing others' accounts, will be eliminated. For these reasons, the extension of NOW accounts nationwide represents a logical, wholly desirable step in the direction of increasing the overall efficiency of the banking system.

The growth and success of NOW accounts in New England reflects consumer acceptance of the service. NOW accounts were authorized for all depository institutions in Massachusetts and New Hampshire on January 1, 1974 and in Connecticut, Maine, Rhode Island and Vermont on February 28, 1976. After three years, 1.2 million NOW accounts totaling over $1.6 billion have been opened in Massachusetts and New Hampshire and 77 percent of the depository institutions were offering these accounts. NOW account balances amounted to 5.5 percent of total commercial bank deposits and 2.8 percent of mutual savings bank deposits at the end of 1976. In the other four New England states, 52 percent of the authorized institutions had 123,000 NOW accounts totaling $402 million at the end of 1976.

Moreover, the experience of institutions in New England indicates that thrifts and commercial banks alike can compete in a wholly safe and sound fashion. At present, we know of no bank that is on the FDIC problem bank list as a direct result of NOW accounts. Some banks offering NOW accounts have suffered an earnings decline, although it is not clear that NOW accounts are the cause. In the opinion of FDIC examiners, problems caused by NOW accounts are unlikely to be much greater than those encountered when "free" checking accounts and consumer certificates of deposit were offered. Well managed banks should experience no significant adverse effects if NOW accounts are authorized, although marginal banks may experience somewhat greater adverse effects in absorbing costs and employing funds profitably, as is the case with any new promotional offering. Thus, in those states where NOW accounts were authorized without a transition period and where most institutions pay the commercial bank passbook savings ceiling of 5 percent, no institution has failed and none has been judged to be in an unsafe and unsound condition because of NOW accounts. In short, our examiners report that the ability of an institution to manage change and maintain profitability depends predominantly on the caliber of its management.

This conclusion, based on the experience and reports of our examination force, is also supported by the tentative results of staff studies currently underway at the FDIC.

For example, Massachusetts commercial banks' average return on total assets before taxes and securities transactions declined 32 percent from .94 percent in 1972, the year before mutual savings banks first began offering NOW accounts, to .64 percent in 1976. Although this is a substantial decline, there is reason to believe that NOW accounts may have played only a small role, or none at all. For example, the spread between interest earned and interest paid relative to total assets actually increased from 3.06 percent in 1972 to 3.70 percent in 1976. This implies that the return on assets actually would have increased over the period if the ratios of non-interest revenues and expenses to total assets had remained the same. Wages and salaries, occupancy expense, provision for loan losses and other operating expenses relative to total assets all increased over the period. In fact, if the provision for loan loss expense is added back to earnings before taxes and securities transactions, the earnings rate actually increased from 1.12 percent in 1972 to 1.27 percent in 1976. Comparable nationwide figures were 1.11 percent in 1972 and 1.35 percent in 1976. This casts considerable doubt on the contention that NOWs have hurt commercial bank earnings in Massachusetts.

Massachusetts insured mutual savings banks hold approximately 5 percent of total mutual savings bank assets. Their return on assets before taxes and securities transactions declined 22 percent from 1972 to 1976.

However, the return on assets declined by the same percentage for all mutuals over the same period. Most of mutual savings bank assets are situated in New York where NOW accounts have not been authorized.

Some concern has been expressed that competition for nationwide NOW accounts will impact earnings unfavorably during the first years after its introduction. Our staff analysis indicates that earnings of commercial banks would not be seriously impaired after the implementation of S. 1664, assuming that the Federal Reserve pays 2 percent on all required reserves, the Federal Reserve requires reserves of 5 percent against NOW account and share draft balances, and institutions pay 5 percent on NOW deposits and share drafts. The impact on earnings will vary somewhat between Federal Reserve member and nonmember banks and for banks of different size. We expect earnings declines to be lower for member banks than for nonmembers. Under certain assumptions, some member banks will increase their earnings primarily as a result of gains from reserve requirement adjustments and interest paid on required reserves.

Even under the most extreme assumptions of a 5 percent interest rate on NOW accounts, no change in service charges, and a 35-50 percent conversion of household demand deposits to NOW accounts, we estimate that the average member bank would experience only a 5-10 percent decline in total earnings over the first few years. Given the more likely scenario of a 5 percent interest rate on NOW accounts and an increase in service charges equal to 2.5 percent on average balances, earnings are estimated to decline by less than 5 percent on the average.

Because state reserve requirements are generally lower than Federal Reserve member bank reserve requirements, nonmember banks will not benefit from reserve requirement adjustments or interest paid on reserves. Again, under the most extreme assumptions mentioned above, earnings of the average nonmember bank would be reduced by 15 to 20 percent. However, I expect that banks have learned from the NOW account experience in New England and will move toward more rational pricing of NOW account services. If this occurs, the earnings decline for the average nonmember bank will be less than 10 percent.

The movement to nationwide NOW accounts may result in higher earnings for thrift institutions and credit unions. Assuming that these institutions acquire 25 percent of the household demand deposits of commercial banks that are converted to NOW accounts, and under the extreme assumptions of a 5 percent interest rate on NOW accounts and no service charge increases, our estimates indicate that these institutions, on the average, would suffer earnings declines of only 5 percent. But, with service charge increases equal to 2.5 percent of average balances, thrifts and credit unions stand to improve their earnings from 15-20 percent.

Another staff study has developed estimates of the costs of servicing individual NOW accounts having various characteristics and has assessed the impact of alternative interest rate and service charge policies on NOW account profitability. The analysis is based on the Federal Reserve's 1974 and 1975 Functional Cost Data Base, and the known characteristics of NOW accounts in Massachusetts and New Hampshire for December 1976. It costs about 2.0 percent of average balances to service a commercial bank NOW account and 2.7 percent of average balances to service a mutual savings bank NOW account. The difference in rates is due primarily to an average account balance of $2,000 in commercial banks versus $800 in mutual savings banks. The larger average account balances in commercial banks apparently result from the combining of savings and checking accounts, while mutual savings bank NOW accounts are essentially similar to personal checking accounts in commercial banks. The study concludes that if personal checking and regular savings accounts are combined, commercial banks charging 10 cents for each draft can afford to pay 4.0 percent interest without hurting existing profit levels. Banks charging 20 cents per draft can afford to pay about 4.75 percent. Furthermore, if customers wrote as many drafts on their NOW accounts as are written on average on personal checking accounts, banks could easily pay 5 percent interest without reducing profits. Finally, the study concludes that a 5 percent interest rate should induce a more rational pricing of NOW account services than any lower rate. Lower rates are likely to reduce average NOW account balances, make it less likely that checking and savings balances will be combined, and retard rational pricing decisions.

Based on the considerations I have outlined and the fact that the move to NOW accounts poses no significant threat to safety and soundness, I support wholeheartedly the Administration's proposal to expand NOW account authority nationwide. I do, however, have certain reservations and questions regarding specific provisions of Title I of S. 1664 and will attempt to outline what I believe to be more desirable alternatives for your consideration.

The Ceiling Setting Mechanism

Section 104(a) of S. 1664 provides for the setting of an interest rate ceiling on NOW accounts and share draft accounts during a transition period and is presumably aimed at providing banks with time to adjust to the payment of interest on NOW and share draft accounts. The initial ceiling on these accounts would be set by a committee composed of the Chairman of the Federal Reserve Board, the Chairman of the Federal Deposit Insurance Corporation, the Chairman of the Federal Home Loan Bank Board, the Administrator of the National Credit Union Administration or their designees. In the event that the agencies are unable to reach a majority decision on the rate ceiling within six months after the enactment of the legislation, the initial rate would be determined by the Federal Reserve Board with changes effected only by majority vote of the four agencies. The bill provides further that rate setting authority shall expire three years after the effective date of the act. Then for a period of three years after that expiration date, the agencies would have standby authority to impose a ceiling if a majority of the agencies determines that a continuation or reimposition of the limitations is appropriate. After six years, the authority would expire altogether.

I have several problems with Section 104(a). As the bill stands, it would become effective one year after enactment. At that time, the three-year authority would come into play. With the further standby authority for three more years, financial institutions could have up to seven years to adjust. It should be recalled that the institutions in New England had no such transition period, and as I have indicated, in New England, which was especially hard hit by the recession and by general economic decline in the region, no bank has been accorded problem status directly or indirectly as a result of excesses in dealing with NOW accounts. Certainly no bank failure can be attributed to NOW accounts in New England. There is little reason to believe that bankers elsewhere would act less prudently. Indeed, with the lessons of the New England experience well known, there is every reason to believe that the adjustments would be made more smoothly. Thus, we at the FDIC do not believe that safety and soundness considerations weigh heavily in support of any transition period.

Given the experience of our examination staff and the tentative conclusions suggested by available data, I cannot recommend that Congress provide a transition period to cushion the impact of offering NOW accounts. Certainly, seven years' authority, even partly on a standby basis, would be unfair to consumers and potentially counterproductive for banks.

However, if Congress should decide that an adjustment period is necessary, then a schedule of rates moving quickly to the commercial bank passbook savings ceiling rate should be set forth in the legislation. I believe that only in the context of certainty will most institutions make the management and policy adjustments necessary in a world of explicit pricing.

Finally, assuming that Congress chooses to give the agencies discretionary authority rather than fixing by statute the ceiling rate to be paid during a transition period or eliminating a transition period altogether, Section 104(a) is far from optimal. It would be preferable to rely instead on the existing mechanism under which interest rate ceilings are currently established -- modified appropriately to include the National Credit Union Administration. Certainly there is no logical reason why the Federal Reserve System should be given primacy for setting the rates on NOW accounts, particularly when the ostensible concern in setting such rates is not monetary policy, but the safety and soundness of banks during the transition period. I believe that there is great danger in charging one agency which regulates 1,023 State member commercial banks with primacy in a rate setting mechanism which affects 35,276 depository institutions varying greatly in size and powers.

It follows, of course, from this that I find the ceiling setting provisions of S. 1667 more objectionable because that proposal would consolidate <u>all</u> interest rate ceiling setting authority in the Federal Reserve Board. No agency with jurisdiction over only certain depository institutions should have rate ceiling setting authority over all such institutions. This point has been brought home to me dramatically at the FDIC as a result of our supervisory responsibilities vis-a-vis mutual savings banks. Because of these duties, we, as an agency, are well acquainted with their problems and goals and with the perspective of thrift institutions, as well as commercial banks, which in my judgment results in a more balanced view.

The Grandfathering Provision

A separate set of concerns arises as a result of Section 104(b), which provides, as I read it, not for the grandfathering of institutions currently authorized to offer interest-bearing third party payment accounts, but rather only for grandfathering individual deposit and share draft accounts which at the time of enactment of the legislation paid a rate of interest higher than the initial ceiling.

This provision reflects a recognition that it would be inequitable and unfair to roll back the rates of interest now paid to consumers on transactions in New England and to a far lesser extent around the country. Because any grandfather provision is to a certain degree inequitable, the problem in drafting such a provision involves devising one which minimizes inequity as well as the cost of enforcement and compliance. Addressing this problem, I assume that the drafters considered at least two other alternatives to the scheme devised. First of all, instead of focusing upon individual accounts, the legislation might have grandfathered those institutions which, at the date of enactment or some other date, were actually offering interest rates higher than the initial ceiling. Alternatively, the legislation might have grandfathered those classes of institutions which at the date of enactment or some other date had already been authorized to offer an account at a rate higher than the initial ceiling.

Among the three possible choices, my strong preference would be for the last. In my judgment, the choice set forth in S. 1664 is the least desirable, both because it is the most inequitable and because it involves the establishment of yet another costly and burdensome regulatory apparatus.

Although the FDIC staff has not yet determined precisely what would be entailed, it is clear that the problems associated with enforcement of such a provision would be substantial. An effective enforcement effort would at least require additional bank examination procedures, the imposition of recordkeeping requirements and the application of formal enforcement machinery where necessary. Paralleling regulatory costs are the costs which must be borne by institutions in establishing procedures to assure compliance. These costs would, of course, fall most heavily on smaller institutions. It is ironic, indeed, that a ceiling-setting apparatus aimed at minimizing bank costs might well generate significant additional costs.

And, while any grandfathering involves certain inequities, it strikes me that the proposal contained in S. 1664 is especially unfair. Such a provision would tend to penalize the cautious institution which had not rushed aggressively into the NOW account experiment and the unsophisticated depositor who may not have fully understood his or her options.

Most of these objections to Section 104(b) as drafted would be met by a provision which would simply allow those classes of institutions that are currently authorized to offer accounts at a rate higher than the initial ceiling set by the agencies under this law to offer such accounts at rates up to the commercial bank ceiling rate for passbook savings during the transition period. This would be simple and far less costly from an enforcement and compliance point of view; would involve no inequity within a given market area; and would involve the least amount of rollback of services currently offered consumers.

It should be noted, of course, that the problems associated with grandfathering would not exist if the transition period were simply eliminated. As I indicated earlier, the facts and analysis which I have seen do not warrant either the costs or inequities associated with grandfathering.

The Definition of NOW Accounts and Enforcement Mechanism

Section 101(c) of S. 1664 defines the term "negotiable order of withdrawal account" as:

> ...a deposit or account (1) on which payment of interest or dividends may be made, (2) with respect to which the depository institution may require the depositor or account holder to give notice of an intended withdrawal not less than thirty days before the withdrawal is made, and (3) on which the depositor or account holder is allowed to make withdrawals by negotiable or transferable instrument or other similar item for the purpose of making payments to third persons or others. Such deposit or account shall consist solely of funds in which the entire beneficial interest is held by one or more individuals.

In his letter to the President of the Senate, Secretary Blumenthal stated that "A NOW account or share draft account is an interest earning account on which checks may be drawn." By so restricting the definition to accounts on which checks or other similar instruments may be drawn, the bill avoids the coverage of accounts which are accessed solely by telephonic or electronic means. This approach is altogether preferable to one which would automatically subject those facilities to the regulatory and definitional constraints of the Act.

Section 103 of S. 1664 provides:

> In order to prevent evasions of the interest rate limitations and reserve requirements imposed by this Act, after consultation, the Board of Governors of the Federal Reserve System, the Board of Directors of the Federal Deposit Insurance Corporation, the Federal Home Loan Bank Board and the Administrator of the National Credit Union Administration are further authorized to determine by similar regulation or order that an account or deposit on which the payment of interest or dividends may be made is a negotiable order of withdrawal account or share draft account where such account or deposit may be used to provide funds directly or indirectly for the purpose of making payments or transfers to third persons or others.

This provision provides each of the banking agencies with the authority to determine by similar regulation or order that an account or deposit used to provide funds is a NOW account where the effect of such an account is to evade the thrust of the Act. This is an appropriate specification of regulatory authority and one which is appropriately dealt with by each of the agencies vis-a-vis the institutions which they regulate. Taken with the definition of NOW account in Section 101(c), this provision provides the means of eliminating evasions of the thrust of the Act without establishing a structure which would roll back existing facilities or stifle future innovations involving telephonic or electronic procedures.

II. Interest on Reserve Balances and the Relationship of Nonmember Institutions to the Federal Reserve System

Title II of S. 1664 includes two very important provisions pertaining to reserve balances with the Federal Reserve System. It would require that nonmember institutions maintain reserve balances on NOW accounts equal to those applicable to member bank NOW accounts, with provision for such requirements for nonmembers to be phased in over a four-year period. Title II would also permit the Federal Reserve to pay interest on required reserve balances maintained within the System. These provisions would have important implications for the competitive position of member versus nonmember institutions and for the structure of the banking system. These issues are quite complex and are not necessarily related to permitting interest-bearing NOW accounts on a national basis. It therefore seems preferable to me that these issues be separated from S. 1664 and subjected to more thorough study.

For the most part, the proposal for payment of interest on required reserve balances grows out of the Federal Reserve's concern with declining membership. There has been a slow but steady erosion of Federal Reserve membership as nonmember banks leave the System. Member banks held 83 percent of total domestic commercial bank deposits in the U.S. in 1965, and that has dropped to 74 percent at the present time. The Federal Reserve's concern about this decline focuses on its ability to conduct monetary policy. While the erosion of Federal Reserve membership does have an impact on the role of the Federal Reserve as a supervisor of banks, in the view of most independent observers, this decline in membership does not have a significant impact on monetary policy.

The Federal Reserve has stressed that the precision with which monetary policy can be carried out is adversely affected by the growing percentage of bank deposits accounted for by nonmember banks. The same line of reasoning appears to underlie the proposal to extend reserve requirements to the NOW accounts of nonmember institutions.

Of course, estimating the impact on the monetary aggregates of a particular change in reserves becomes more difficult when different banks are subject to different reserve requirements. But this problem would exist even if all banks were member banks. Under the Federal Reserve's reserve structure, time deposits are subject to different requirements than demand, and different classes of member banks are subject to varying reserve requirements. Hence, a shift of funds among member banks has precisely the same effect of blurring the precision of monetary policy that disturbs the Federal Reserve when nonmember banks are involved.

There have been several studies of the monetary control issue by economists outside the Federal Reserve. All of those that I am familiar with have concluded that increased Federal Reserve membership is not important to the effectiveness of monetary policy, at least with member banks comprising the proportion of the money supply that they do now.

There have been two major empirical studies which attempted to ascertain the impact of nonmember banks on the implementation of monetary policy. The first was conducted by Clark Warburton for the Commission on

Money and Credit. Warburton concluded that nonmember banks are affected by Federal Reserve monetary policy actions in approximately the same way that member banks are. Another investigation was reported recently by Dennis Starleaf of Iowa State University. In Starleaf's study, the actual M_1 money multiplier for the period 1962-1972 was compared with a money multiplier series simulated under the assumption that all banks were subject to Federal Reserve reserve requirements. That is, the simulation indicated that had nonmember banks been subject to such reserve requirements, the money stock would have experienced even greater variations. Starleaf thus rejected the argument that uniform Federal Reserve reserve requirements are necessary for the implementation of monetary policy.

There have also been a number of articles that attempted to analyze the logical arguments and the empirical data that exist on this issue. The Hunt Commission concluded that "reserve requirements are unnecessary for open market operations to control the monetary base effectively." Carter Golembe, after discussing the difficulties in conducting monetary policy with precision, concluded that,

> ...so many factors contribute to the lack of precision and certainty that simply changing the proportion of deposits subject to Federal Reserve requirements from almost 80 percent to nearly 100 percent would be of relatively minor importance.

In a 1974 study, Professors Ross Robertson and Almarin Phillips investigated the argument that nonmember banks behave in a manner different from member banks, and that such behavior thwarts implementation of Federal Reserve monetary policy. They concluded that these arguments have no validity:

> This contention deluded those who are innocent of money matters and even a few who should know better. As has been observed, open market operations are for all practical purposes the instrument of monetary control. Like the rain from heaven that falls on us all, regardless of our merits, open market operations affect member and nonmember banks alike. There is not one shred of evidence to the contrary.

A study conducted by Gary Gilbert and Manferd Peterson found results similar to Robertson and Phillips. They concluded that,

> ...the behavior of nonmember banks under varying degrees of monetary ease or restraint is relatively similar to that of country member banks. To the extent that systematic behavior of the demand deposits components is important for the effective control of the money supply, there is no indication from available evidence that the nonmember banking segment has hampered monetary policy.

Several of these studies have stressed the caveat that while the Federal Reserve can control the monetary aggregate without member banks or without reserve requirements, it does need good information on the reserves and deposits of all banks. S. 1664 covers that point by requiring that all banks offering NOW accounts submit reports on deposit liabilities requested by the Federal Reserve. We support this proposal and believe that the Federal Reserve should be authorized to obtain all of the information it needs to conduct monetary policy.

Several years ago, the Federal Reserve became concerned about the adequacy of its data on the money supply, and established a committee, chaired by Professor George L. Bach of Stanford University, to recommend changes in money supply statistics. One of the major recommendations of the Bach Committee was that better and more frequent data on nonmember bank deposits was desirable. Following that report, the FDIC instituted a weekly survey of a sample of nonmember banks in order to provide the Federal Reserve with better information on the money supply. This collection was initiated with the spring 1976 Call Report.

A second step, also recommended by the Advisory Committee on Monetary Statistics, is scheduled to go into effect in the first week of July this year. A sample of 580 nonmember banks will be asked to report deposit and cash items on a regular weekly basis, the same items as all nonmember banks do four times a year. The Federal Reserve has indicated that they expect that the use of the data from the two projects mentioned will enable them to achieve significant improvements in their estimates for the nonmember bank component of the nation's money supply.

Concern with the effectiveness of monetary policy is not the only argument that has been advanced in support of mandatory Federal Reserve membership and the imposition of Federal Reserve reserve requirements. The issue of equity is an important one. The equity arguments in support of a uniform reserve requirement structure focus on the issue of competitive advantage. As stated earlier, nonmember banks are subject to diverse state reserve requirements. All states permit banks to count vault cash and correspondent balances as reserves. Approximately 20 states allow banks to hold some part of reserves in earning assets. On the other hand, Federal Reserve member banks must hold reserves in the form of vault cash or non-interest earning deposits at a Federal Reserve bank. Insofar as correspondent balances and earning assets do not qualify as reserves for member institutions, nonmember banks (at least in those states counting some earning assets as reserves) have a competitive advantage over member banks in that they have an opportunity to invest a larger proportion of their funds in earning assets.

Many view this as an inequitable situation. Others point out that since membership in the Federal Reserve is voluntary, and since all banks that are members of the Federal Reserve have made their judgment as to whether membership is worthwhile or not, there cannot be any serious issue of equity involved. In a major study for the Conference of State Bank Supervisors, Dr. Lawrence Kreider found that most state banks that are members of the Federal Reserve are receiving benefits in the form of correspondent business that makes Federal Reserve membership attractive to them. To the extent that equity is a problem and member banks are being treated unfairly, I believe that the payment of interest on reserve balances, if handled properly, would resolve the problem. A lowering of member bank reserve requirements could also be used to achieve the same end.

In summary, I believe that the reserve provisions of the proposed legislation could have significant implications for the banking system that need to be examined carefully. I do not oppose the payment of interest on reserves by the Federal Reserve although I would prefer to see Congress deal with that issue separately from NOW accounts. I do oppose that provision of Title II that imposes reserve requirements on NOW accounts of nonmember institutions. The extension of such requirements for monetary control purposes, as I have indicated earlier, is not supported by the weight of available evidence. The thrust of the evidence to date suggests that the monetary problem is one of adequate data and proper estimation procedures rather than reserve requirement jurisdiction. And, even if the case could be sustained for the proposition that uniform reserve requirements are necessary for the effective conduct of monetary policy, certainly the requirement of uniform reserves on NOW accounts would not achieve the desired effect. The subject of the relationship of nonmember institutions with the Federal Reserve is one on which I have an open mind but one which I believe should be dealt with carefully and with reasoned study.

III. <u>Extension of Regulation Q Authority</u>

Title III of S. 1664 would extend to December 15, 1979, the flexible authority to impose interest rate ceilings on deposits. In his letter forwarding this bill to the President of the Senate, Secretary Blumenthal stated that, "this would allow the Administration sufficient time to study the impact of (1) Regulation Q on financial intermediaries, consumers, and the mortgage market, and (2) the elimination of unnecessary Federal regulatory constraints." Although I do not object to a two-year extension of Regulation Q authority in order for the Administration to develop its position on this matter, I would prefer that the Congress face up to the issues raised by Regulation Q and the rate differential this session and devise a strategy for phasing out this inefficient and inequitable form of credit allocation now.

Notwithstanding the linkage of interest rate ceilings and housing goals, the ceilings are an inefficient means of assisting housing and assuring the stability of thrift institutions. Regulation Q simply does not work well as a device for allocating funds to housing. Although it may protect thrift institutions from commercial bank competition to a certain extent, it does not protect them from competition from the unregulated money market. In times of high interest rates, such as was the case in 1966, 1969-70, and 1973-74, many depositors forsake depository institutions and invest their funds directly in market instruments. As a result of this disintermediation, the mortgage market dries up and thrift institutions suffer earnings and liquidity pressures.

Moreover, even if the ceilings were effective in assuring a stable flow of funds to the housing market, they would still be highly objectionable because they constitute a regressive and inequitable tax on small savers. With respect to this matter, I have been puzzled by the relative silence in the past of consumer spokesmen, but I am heartened by recent statements by consumer representatives favoring the abolition of Regulation Q. The inability of the small and unsophisticated saver to obtain market rates of interest on his passbook savings, while sophisticated larger investors are able to achieve market rates, should be a major consumer issue.

In short, because I believe that interest rate ceilings are an ineffective and sometimes disruptive form of credit allocation and because I believe that they impose significant inequities on small savers, it is my judgment that the proper focus of our attention should be upon how and when, and not whether, to phase out interest rate ceilings. For this reason, I favor designation of a specific date for their demise. I believe that only in the context of such certainty will bankers and regulators begin to plan seriously.

While working toward the phasing out of this particular restriction which serves to protect the less efficient institution, action should also be taken to eliminate other restrictions which place unnecessary and burdensome costs on depository institutions -- costs which inevitably work to the detriment of the consumer as well as the banker. One particularly noteworthy set of restrictions which parallels the Regulation Q ceilings on the other side of the balance sheet is usury laws imposed in some states. As I indicated earlier, our examination force has informed us that the NOW account experiment in New England has had no significant effect on the safety and soundness of banks there. This is not the case with respect to usury laws in various states. For example, in Tennessee, usury laws have imposed a profound restraint on banks and, in the minds of many, constituted one reason why Hamilton Bancshares, Inc., chose to use Hamilton Mortgage Co. as a vehicle to generate increased revenues, a decision which subsequently led to the failure of Hamilton National Bank of Chattanooga.

I am not so unrealistic as to believe that the movement toward market pricing of deposits can be accomplished overnight, even though the time is probably ripe to phase out the ceilings. However, I do believe that it is important that we work toward the establishment of meaningful phase-out of these controls in a context that safeguards financial institutions. This cannot be accomplished without the constructive and forthright political leadership of the Congress and others aimed at eliminating artificial constraints of this type and developing alternative strategies to assure an adequate flow of funds to housing. The result will redound to the benefit of the consumer and financial institutions alike.

IV. Federal Chartering Option for Mutual Savings Banks

Title I of S. 1665 and Title VII of S. 1666 would provide a federal chartering option for mutual savings banks. I strongly favor immediate adoption of legislation which would provide a federal chartering option for mutual savings banks.

Mutual savings banks have moved a long way down the road in the evolution toward being "full service family banking institutions." In some states, mostly in New England, this evolution is virtually complete. In other states, however, there are important gaps in savings bank powers and restrictions on their operations. In New York, for example, savings bank lending powers are restricted and there are important limitations with respect to demand deposits. It is true that some state laws are unduly restrictive with respect to commercial banks as well, but the choice provided by the dual banking system means that innovations which genuinely satisfy customer needs will be adopted over time.

It is clear that regulatory decisions in the early sixties which gave national banks powers already possessed by some state banks helped banking meet the challenges of a changing economy. Similarly, state legislatures and state regulators have taken the lead in pursuing alternative strategies of dealing with financial reform and electronic funds transfer systems. As a result, the states often serve as laboratories where innovation can provide insights as to the best approach to take at the federal level. In my judgment, mutual savings banks and their customers should not be denied the considerable benefit of this unique and positive feature of American financial regulation. While I do support the federal chartering option for mutual savings banks, I would like to enumerate some suggestions for implementing this objective.

First, I do not favor restricting the federal chartering option geographically, nor do I favor limiting this option to existing institutions. It seems to me that mutual savings banks have been effective, viable competitors in the 17 states where they exist and there is no reason to limit their benefits to these states. Second, I think it appropriate to point out that the FDIC has more than 40 years of experience in examining and supervising the mutual savings bank industry -- experience which would be most useful to a chartering authority. It seems to me that your Subcommittee should not overlook our long experience in this area in determining who should be the chartering authority for federal mutual savings banks. It seems highly desirable to us that there be at least one federal financial institution regulator which is concerned with both commercial banks and thrift institutions in order to ensure a balanced regulatory perspective. I know, for example, that this is most useful in our deliberations with respect to interest rate ceilings.

The third point which I would raise arises out of Section 103 of S. 1665 and Section 701(d) of S. 1666 which provide in essence that when a mutual savings bank insured by the FDIC converts to or consolidates with a federal savings bank insured by the FSLIC, the FDIC would be required to transfer to the FSLIC that bank's accumulated insurance assessment, less the bank's pro rata share of FDIC operating expenses and insurance losses. This approach seems to assume that an insured bank, by paying deposit insurance asessments, builds up some sort of entitlement to a pro rata share of the Federal deposit insurance fund which it can take with it to the new insuring entity (FSLIC). It should be noted that if the converting bank failed prior to its conversion, assessments against other FDIC-insured banks would have had to make up any loss to the Federal deposit insurance fund. Accordingly, the fund should not be required to rebate any part of previous assessments, which should be regarded as payments for the benefits of past insurance coverage received by the converting bank.

Deposit insurance has been viewed as more in the nature of casualty or term life insurance rather than whole life insurance in that a bank's deposit insurance assessment pays for current coverage and should not be refunded upon cessation of insured status. This is supported by the case law which indicates that an insured bank builds up no "cash value" in paying its insurance assessments.

In addition, our staff has expressed serious reservations about the workability of the formula detailed in these two bills. Indeed, the staff believes that it would be virtually impossible to accomplish a transfer consistent with the provisions of the bills as drafted. I have requested the staff to prepare a detailed analysis of this matter and will be happy to provide the Subcommittee with the results of that analysis.

I reiterate, however, my support of a federal chartering option for mutual savings banks and urge that these technical and policy problems be resolved expeditiously and not serve as a reason for delay in adopting this long overdue measure.

V. Extension of Deposit Insurance

Title III of S. 1666 pertains to insurance of deposits. Section 301 requires the Federal Deposit Insuance Corporation, the Federal Savings and Loan Insurance Corporation, and the National Credit Union Administration to insure public deposits for the full amount thereof. Section 302 removes the dollar restriction on insurance of accounts for retirement savings placed in Individual Retirement Accounts and Keogh plans and provides for full deposit insurance for such accounts at federally insured savings and loan associations.

The proposal to fully insure public deposits is timely in light of the study, "The Impact of Increased Insurance on Public Deposits," submitted by the Advisory Commission on Intergovernmental Relations to the Committee on Banking, Housing and Urban Affairs of the United States Senate. In that study the Advisory Commission recommended that "the appropriate Federal agency insure the full amount of public deposits in commercial banks, savings and loan associations, mutual savings banks and credit unions." It also recommended that federally insured deposits not be subject to any pledging requirements and that the total amount of public deposits in a single financial institution should be limited to a reasonable percentage of total deposits and/or total capital.

In 1974, the FDIC interposed no objection to the principle of full deposit insurance for public funds. However, it has been the Corporation's view, as stated by former Chairman Frank Wille in his testimony before your Subcommittee on March 19, 1974, that full coverage of public deposits should be accompanied by a provision which would require the FDIC, the Federal Savings and Loan Insurance Corporation, and the National Credit Union Administration to prescribe uniform restrictions with respect to the aggregate amount of public funds that could be deposited in a bank, a savings and loan association or credit union. This provision has also been recommended by the Advisory Commission on Intergovernmental Relations. Although present law authorizes the imposition of such limitations as to time and savings deposits, there is no authority in present law or in S. 1666 to apply such limitations to demand deposits and no requirement that any such limitations be uniform as to all depositories. Absent such a provision, we would oppose enactment of Section 301 in its present form.

Section 302 of S. 1666 as drafted is wholly inappropriate in that it extends full deposit insurance to Individual Retirement Accounts and Keogh accounts held only in savings and loan associations. Enactment of this provision would give savings and loan associations an unwarranted and substantial advantage in competing for these accounts. Although an argument can be made for the proposition that these accounts serve as a substitute for pension funds and should be accorded full protection rather than forcing individuals concerned about the safety of their accounts to establish more than one account, there is certainly no reason to limit full coverage on these accounts to a specific type of financial institution. We would, therefore, oppose this provision vigorously.

In my judgment, these issues are of sufficient importance and complexity to warrant separate consideration, and I would recommend that hearings be held specifically on the subject of deposit insurance.