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Statement on

Consumer Financial Services Act (S.2055)

Presented to

Subcommittee on Financial Institutions
Supervision, Regulation and Insurance
House Committee on Banking, Finance and Urban Affairs
House of Representatives

by

George A. LeMaistre
Chairman, Federal Deposit Insurance Corporation

September 7, 1977

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Mr. Chairman, I welcome this opportunity to testify on the Consumer Financial Services Act (S. 2055) as reported out of the Senate Committee on Banking, Housing and Urban Affairs on August 3.

As I indicated in testimony before the Senate Subcommittee on Financial Institutions on June 20, 1977, we at the FDIC support the proposal to expand NOW account authority nationwide. The legislation before you also deals with a number of other topics. In addition to discussing the NOW account provisions, I will discuss parts of this legislation which are of major significance, which directly affect the FDIC or in which the FDIC has special expertise. I wish to 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 own analysis proceeds.

Before commenting specifically on this legislation, I would like to touch briefly on the matter of financial institution reform in general because my specific comments flow directly from certain basic principles. As you know, I supported the recommendations of the HUNT Commission and the broad goals embodied in both the Financial Institutions Act and the Financial Reform Act. I was heartened when the Financial Institutions Act of 1975 was passed by the Senate and by the general thrust of the FINE study in the House. However, I was disappointed at the subsequent demise of the Financial Reform Act 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 recommendation that financial restructuring should not be accomplished piecemeal, but rather in a context of a comprehensive legislative package designed to provide as equitably as possible for a transition to the new structure.

Nevertheless, events have shown that supporters of comprehensive financial reform were a bit naive. Accordingly, it seems to me that we should work to develop 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 inject a note of caution. Since the recommendations of the Hunt Commission in 1971, developments in the market-place and at the state level have moved us toward the goals the Hunt Commission envisioned. Competition among financial institutions has increased and innovative strategies, such as the use of telephone and electronic transfers and money market funds, have undercut the effectiveness of interest rate ceilings and the prohibition of interest payments on demand deposits. In this context, we must take special care not to 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 resisted even in the face of our frustration with the failure of financial reform in the past.

Rather than attempting to review all the issues before us today, I shall focus on five issues in S. 2055: (1) the extension of NOW and share draft account authority provided in Title I; (2) the provisions of Title II dealing with the problem of membership attrition 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 Title III; (4) the provision of a federal chartering option for mutual savings banks in Title IV; and (5) the broadening of federal deposit insurance coverage on IRA and Keogh accounts provided for in Title VI. Because of our responsibility to monitor NOW account developments, I shall give special emphasis to our on-going analysis of the New England experiment with NOW accounts.

I. NOW and Share Draft Account Authority

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. They have also 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 lead to substantial benefits for both financial institutions and bank customers.

Under the present system of implicit interest payments on checking accounts, depositors are denied the opportunity to determine for themselves how they wish to spend their portion of the income the bank earns on their deposits. If interest were paid, a depositor might choose to consume the same services that banks now offer in the course of competing with other institutions for his account or he might choose to forego such services and spend his interest income on different goods and services. This is an important benefit of NOW accounts -- consumers will make the decision as to how to spend their interest income, not the banks.

Free or below-actual-cost checking encourages inefficient use of resources because depositors have little or no incentive to economize on check writing, even though check clearance costs are substantial. Direct charges for checks are likely to prompt depositors to write fewer checks. Such fees should cover a substantial cost of clearing checks. Management's adoption of pricing policies more nearly in line with the costs of providing services to customers will enhance a financial institution's capability of paying a competitive interest rate on deposit balances without impairing earnings.

Payment of competitive interest rates will lower some operating costs by reducing the need to transfer funds between non-interest bearing checking accounts and savings accounts as depositors no longer find it necessary to maintain separate checking and savings accounts. Customers will need to spend less time and effort in managing deposit balances, particularly when interest rates are high. Also, existing inequities, whereby some depositors pay for a smaller portion of the cost of servicing their accounts than other depositors pay will be eliminated.

Some have argued that NOW accounts would penalize depositors with small balances because they would be forced to pay for services that are now free. For this to be true, interest payments on their deposits would have to be less than service charges, assuming they paid nothing for a checking account prior to the advent of NOW accounts. And, if interest payments were less than service charges, this would imply that these depositors were not paying for the fair value of services received on free checking accounts. Furthermore, if NOW accounts are authorized, depositors will still be able to choose a conventional checking account.

Moreover, available statistical evidence does not clearly demonstrate that the average small depositor would end up as a loser in a world with NOW accounts. According to the Federal Reserve System's 1976 Functional Cost Analysis figures, an average personal checking account in a typical bank with less than $50 million in total deposits had a balance of $874 and cost the bank, net of service charges, $37.08 a year. This amounts to an implicit interest rate of 4.25 percent. If the bank paid 4.25 percent on an $874 NOW account and raised service charges by $37.08, the bank would not be worse off and the depositor would be worse off only to the extent that he would have to pay income taxes on his interest earnings. While the annual cost of servicing an account with a balance smaller than $874 is likely to be less than $37.08, the implicit interest rate could well be above 5 percent, which is the maximum ceiling rate presently permitted on NOW accounts in New England. However, it should not automatically be assumed that this is true for every small account nor that banks will necessarily raise service charges on small accounts by amounts exceeding the explicit interest payments on them.

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 and provides depositors with a wider range of options from which to choose.

Experience in New England

The growth and success of NOW accounts in New England reflect consumer acceptance of this 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. By June 30, 1977, 1.4 million NOW accounts totalling over $1.8 billion had been opened in Massachusetts and New Hampshire and 79 percent of the depository institutions in those states were offering such 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 Massachusetts and New Hampshire. In the other four New England states, 53 percent of the authorized institutions had 170,000 NOW accounts totalling $539 million as of June 30, 1977.

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 were the primary 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 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 results of FDIC staff studies.

Study of Commercial Banks That Lost Money in 1976

In one study, our examiners and economists analyzed 22 Massachusetts commercial banks which had negative net current operating earnings before taxes and securities transactions in 1976 to determine whether NOW accounts were responsible for the earnings difficulties of those commercial banks. The examiners concluded that bad debts were the most important factor accounting for negative earnings in these banks. Specifically, the 1976 earnings loss in 14 of the 22 banks can be blamed on heavy loan losses, while loan losses were a major contributing factor in the other eight banks.

These findings are supported by the analysis of our economists. As shown in Table 1, the average earnings figures of the banks grouped according to their involvement in NOWs reveals no clear-cut relationship between the 1976 earnings of the banks and the proportion of their total deposits in NOW accounts. Moreover, the absence of a clear-cut relationship seems to be the case regardless of the service charge policy of the banks offering NOWs (see Table 2). Two earnings measures are reflected in Tables 1 and 2. The adjusted earnings figure reflects the banks' earnings net of their provision for loan losses. Neither earnings figure indicates a clear-cut relation between banks' involvement in NOWs and earnings levels.

A similar absence of any discernible connection between the amount of NOW accounts relative to total deposits or NOW account service charge policy and earnings rates before or after the deduction of the provision for loan losses existed in 17 commercial banks in the other five New England states that had negative earnings in 1976 (see Tables 3 and 4). In fact, the five banks having the greatest proportion of NOW accounts fared the best.

Table 1

Average Earnings Rates of 22 Massachusetts Commercial Banks Having Negative Earnings in 1976 Grouped by Ratio of NOW Deposits to Total Deposits

	Ratio of NOW Deposits to Total Deposits (December 1976)		
	10% or More	10-0%	0[a]
Earnings on Assets[b]	- 1.92	- 1.36	- 1.49
Adjusted earnings on assets[c]	- .01	- .87	.12
Number of banks	7	8	7

a The banks not offering NOWs year-end 1976.
b The earnings are 1976 income before taxes and securities gains and losses.
c The adjusted earnings figure reflects 1976 income before taxes and securities transactions plus the loan loss provision.

Table 2

Average Earnings Rates of 22 Massachusetts Commercial Banks Having Negative Earnings in 1976 Grouped by NOW Account Service Charge Policy

	Free NOWs	Charge Plan NOWs	No NOWs
Earnings on assets	- 1.87	- 1.50	- 1.49
Adjusted earnings on assets	.00	- .10	.12
Number of banks	5	10	7

Table 3

Average Earnings Rates of 17 Commercial Banks Having Negative Earnings in 1976 in New England States Other Than Massachusetts, Grouped by Ratio of NOW Deposits to Total Deposits[a]

	Ratio of NOW Deposits to Total Deposits		
	3% or More	3-0%	0[b]
Earnings on assets[c]	- .79	- 1.11	- 1.23
Adjusted earnings on assets[d]	1.82	.26	.54
Number of banks	5	8	4

a The 17 commercial banks include 10 from Connecticut, 1 from Maine, 2 from Rhode Island, 0 from Vermont and 4 from New Hampshire. New banks established since 1971 and having negative earnings are excluded from the analysis.

b The banks not offering NOWs year-end 1976.

c The earnings are 1976 income before taxes and securities gains and losses, assets are averaged over two consecutive years.

d The adjusted earnings figure reflects 1976 income before taxes and securities transactions plus the loan loss provision.

Table 4

Average Earnings Rates of 17 Commercial Banks Having Negative Earnings in 1976 in New England States Other Than Massachusetts, Grouped by NOW Account Service Charge Policy

	Free NOWs	Charge NOWs	No NOWs
Earnings on assets	0	- 1.01	-1.23
Adjusted earnings on assets	0	.87	.54
Number of banks	0	13	4

Table 5

The Earnings Performance of Commercial Banks Grouped
By State and NOW Account Characteristics

Year	Commercial Bank Group	Number of Banks	Earnings As Percent of Assets*	NOWs As Percent of Total Deposits
	CONNECTICUT			
1976	All banks	57	.594	1.50
	Non NOW	23	.588	--
	NOW-No Service Charge	1	.641	.72
	NOW-Service Charge	33	.597	2.57
	MAINE			
1976	All banks	38	1.063	1.60
	Non NOW	17	1.177	--
	NOW-No Service Charge	2	.706	8.85
	NOW-Service Charge	19	.998	2.27
	MASSACHUSETTS			
1976	All banks	136	.359	--
	Non NOW	31	.227	0.00
	NOW-No Service Charge	21	.068	11.21
	NOW-Service Charge	84	.482	8.84
1975	All banks	136	.670	--
	Non NOW	46	.739	0.00
	NOW-No Service Charge	24	.625	8.53
	NOW-Service Charge	66	.639	4.38
1974	All banks	136	1.024	.53
	Non NOW	94	.987	0.00
	NOW-No Service Charge	9	1.124	2.93
	NOW-Service Charge	33	1.104	1.36

Table 5 - cont'd.

Year	Commercial Bank Group	Number of Banks	Earnings As Percent of Assets*	NOWs As Percent of Total Deposits
	NEW HAMPSHIRE			
1976	All banks	68	.777	6.33
	Non NOW	22	.973	--
	NOW-No Service Charge	7	.855	11.63
	NOW-Service Charge	39	.652	8.96
1975	All banks	68	.876	3.00
	Non NOW	31	1.008	--
	NOW-No Service Charge	12	.632	9.89
	NOW-Service Charge	25	.830	3.56
	RHODE ISLAND			
1976	All banks	11	.814	6.23
	Non NOW	1	1.435	--
	NOW-No Service Charge	0	--	--
	NOW-Service Charge	10	.752	6.85
	VERMONT			
1976	All banks	29	1.072	1.36
	Non NOW	20	1.130	--
	NOW-No Service Charge	0	--	--
	NOW-Service Charge	9	.942	4.40

*Measured on a before-tax basis and expressed as an unweighted average for all banks in each group. The bank data are year-end data except for assets, which are averaged over two consecutive years.

Table 6

The Earnings Performance of Mutual Savings Banks Grouped By State and NOW Account Characteristics

Year	Savings Bank Group	Number of Banks	Earnings As Percent of Assets*	NOWs As Percent of Total Deposits
	CONNECTICUT			
1976	All banks	66	.729	--
	Non NOW	19	.720	--
	NOW-No Service Charge	9	.801	.71
	NOW-Service Charge	38	.683	.28
	MAINE			
1976	All banks	30	.926	--
	Non NOW	13	.962	--
	NOW-No Service Charge	2	.925	1.24
	NOW-Service Charge	15	.834	.70
	NEW HAMPSHIRE			
1976	All banks	27	.844	2.90
	Non NOW	3	.846	--
	NOW-No Service Charge	16	.830	3.54
	NOW-Service Charge	8	.885	2.72
1975	All banks	27	.717	1.81
	Non NOW	5	.458	--
	NOW-No Service Charge	16	.721	2.34
	NOW-Service Charge	6	.923	1.90
1974	All banks	27	.821	.78
	Non NOW	8	.653	--
	NOW-No Service Charge	14	.837	1.19
	NOW-Service Charge	5	1.046	.89
	RHODE ISLAND			
1976	All banks	6	.933	--
	Non NOW	6	.933	--
	NOW-No Service Charge	0	--	--
	NOW-Service Charge	0	--	--
	VERMONT			
1976	All banks	6	.825	.24
	Non NOW	4	.785	--
	NOW-No Service Charge	0	--	--
	NOW-Service Charge	2	.905	.71

*Measured on a before tax basis and expressed as an unweighted average for all banks in each group. The bank data are year-end data.

It should be noted that the results presented in Tables 1, 2, 3 and 4 are not conclusive by themselves because various other factors that might be expected to influence bank earnings have not been taken into account.

Study of Average Earnings in Banks with NOW Accounts and Those Without

In another study, FDIC economists analyzed the impact of NOW accounts on New England commercial bank and mutual savings bank earnings in general. Table 5 shows average earnings rates before taxes and securities transactions for 57 Connecticut commercial banks, 38 Maine commercial banks, 136 Massachusetts commercial banks, 68 New Hampshire commercial banks, 11 Rhode Island commercial banks and 29 Vermont commercial banks. Table 6 shows average earnings rates for mutual savings banks including 66 in Connecticut, 30 in Maine, 27 in New Hampshire, 6 in Rhode Island and 6 in Vermont. Average earnings rates in both tables are also shown for banks grouped according to whether they offer NOW accounts and, if they do, whether they levy service charges.

With the notable exception of Massachusetts and to a lesser extent Connecticut, 1976 earnings rates in commercial banks not offering NOW accounts tended to be somewhat higher than earnings in commercial banks offering NOW accounts. But, with the possible exception of New Hampshire, these differences were slight. Again, with the exception of Massachusetts, there did not appear to be any clear-cut differences in the earnings rates of banks offering NOW accounts based on their service charge policies. The 21 Massachusetts banks offering free NOWs had the worst earnings rates. It should be noted that in both Massachusetts and New Hampshire there has been movement away from free NOW accounts as demonstrated by the decline from 36 such banks in 1975 to 28 in 1976 and that banks in these two states offering NOWs for the first time during 1976 decided to levy service charges.

The earnings figures in Table 5 of banks in the different New England states clearly indicate that Massachusetts banks were especially hard hit by the 1974-75 recession. However, magnitude of the earnings declines in Massachusetts from 1974 to 1976 does not appear to be related to the decision to offer NOW accounts or the choice of service charge policy.

In the five New England states for which mutual savings bank earning rates are shown in Table 6 (Massachusetts is omitted because most mutuals in that state are not federally insured and do not report their earnings to the FDIC), there is virtually no difference in the earning rates of savings banks offering NOW accounts and those not offering NOW accounts.

Study of the Impact of NOW Accounts on 1976 Earnings

While the comparisons of average earnings rates seem to indicate that NOW accounts have had only minor adverse effects on bank earnings, the results of another more comprehensive study of 98 Massachusetts commercial banks, 68 New Hampshire commercial banks and 57 Connecticut commercial banks completed by FDIC economists suggests a different conclusion.* The study employed regression analysis to investigate the relation between 1976 earnings and NOW accounts. The effects of the composition of the

*Only 98 Massachusetts commercial banks had NOW account policies that did not change during 1976.

loan and securities portfolios, time and savings deposits, size of bank, number of branches and Federal Reserve membership on earnings were also explored as part of the same analysis.

The results of that study indicate that earnings before taxes as a percentage of total assets decline as the percentage of total deposits that are NOW deposits increases. In Massachusetts commercial banks, for every one percent of total deposits that shifts from demand deposits to NOW deposits (total deposits remain unchanged), earnings expressed as a percentage of total assets decline approximately .15 in the 14 banks offering free NOW accounts, .07 in the 11 banks charging 10 or 15 cents per NOW account draft and .05 in the 44 banks requiring a minimum NOW account balance and levying some kind of monthly charge and/or other types of service charges. However, if savings deposits shift to NOW deposits, the earnings declines are smaller, .11 in banks offering free NOWs, .03 in banks levying a charge on each NOW draft and .01 in banks having some other NOW account service charge plan.

For every one percent of total deposits that shifts from demand deposits to NOW deposits in New Hampshire commercial banks, earnings decline approximately .06 in the 7 banks offering free NOW accounts and .02 in the 39 banks levying service charges on NOW accounts. And in Connecticut, earnings <u>rise</u> .23 in the 34 banks offering NOW accounts. All but 3 of the Connecticut banks levy service charges. These figures demonstrate that the Massachusetts experience appears to reflect the worst that may happen.

If earnings rates generally decline with increases in NOW deposits, why are there only negligible differences in the average Massachusetts commercial bank earnings rates of .22 for non-NOW banks, .37 for banks offering free NOWs, .44 for banks charging 10 or 15 cents per NOW draft and .30 for banks with other NOW account service charge plans?* In fact, when 10 percent of total deposits are in NOWs, the earnings rates are .52 in banks offering free NOWs, .28 in banks charging 10 or 15 cents per NOW draft and .12 in banks with other NOW account service charge plans. Except for the third group of NOW banks, these earning rates are above the average non-NOW banks. In New Hampshire, the average earnings rates are .97 for non-NOW banks, .75 for banks offering free NOWs and .70 for banks levying service charges on NOWs.

It seems rather apparent that commercial banks offering NOW accounts, especially those in Massachusetts, have made various adjustments which have offset a substantial portion of the earnings decline related to the shifting of demand and savings deposits to NOW accounts. Although the exact sources and amounts of such adjustments are not known, there are several possibilities. Because reserve requirements tend to be lower on NOW accounts, placement of released reserves in earning assets increases revenues. These banks may have also made a concerted effort to improve the rate of return on earning assets by raising lending rates, pricing loans more carefully according to their overall cost including

*These average earnings rates are not the actual group means. Rather, they are those rates that would exist if all banks had the same composition of loans and securities. NOW deposits as a percentage of total deposits is 11.0 percent in banks offering free NOWs, 7.9 percent in banks charging for NOW drafts and 6.6 percent in banks with other NOW account service charge plans.

risk and selecting better yielding earning assets. In addition, banks offering NOWs may have been motivated to scrutinize operating costs, realizing significant cost savings as a result. The results of this analysis of Connecticut, Massachusetts and New Hampshire commercial banks tend to suggest that NOW accounts have required bank management to pay much closer attention to developing and pursuing policies designed to improve profits. To the extent that this has actually happened, NOW accounts have been a powerful force in prodding banks to operate more efficiently.

However, some argue that banks offering NOW accounts have stemmed earnings declines by shifting earning assets into high yielding, extremely risky assets. There is little evidence at this time to substantiate or refute this argument, although I would like to reiterate that our examiners do not feel that any insured New England commercial bank or savings bank is in an unsafe and unsound condition as a consequence of NOW accounts. Nevertheless, there is a general feeling among examiners that if banks have shifted into higher yielding, more risky assets, the most likely banks to have done so are those with weak, incompetent management. Our staff is studying this issue and hopes to develop more conclusive evidence.

There is additional evidence that Massachusetts may represent a worst-case situation for evaluating the impact of NOW accounts on bank earnings. While 83 percent of Massachusetts commercial banks offering NOWs levied service charges at the end of June 1977, comparable figures were 86 percent in New Hampshire, 92 percent in Connecticut, 92 percent in Maine and 100 percent in Rhode Island and Vermont. Similar figures for mutual savings banks were 40 percent in Massachusetts, up sharply from 29 percent at the end of 1976, 36 percent in New Hampshire, 83 percent in Connecticut, 90 percent in Maine and 100 percent in Vermont. In addition, service charge plans in Connecticut, Maine, Rhode Island and Vermont commercial banks have encouraged high NOW account balances ranging from $3,100 to $5,800 versus approximately $2,200 in Massachusetts and New Hampshire. Accounts with high balances generally are more profitable than accounts with low balances.

Study of the Nationwide Earnings Impact of NOW Accounts

Some concern has been expressed that competition for nationwide NOW accounts will impact earnings unfavorably during the first years after their introduction. In addition to the study of Massachusetts commercial banks which suggested that those banks are adjusting to NOWs, another FDIC staff analysis indicates that aggregate earnings of commercial banks would not be seriously impaired after the implementation of S. 2055, assuming that the Federal Reserve pays 6 percent on NOW account reserves, member bank demand deposit and time and savings deposit reserves are reduced, 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.

Given the 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 about a 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 non-NOW account reserves. Again, under the first set of assumptions mentioned above, earnings of the average nonmember bank would be reduced by less than 20 percent. However, I believe that banks have learned from the NOW account experience in New England and will move toward more rational pricing of NOW account services and will make other adjustments to offset any NOW account induced earnings decline. If this occurs, the earnings decline for the average nonmember bank could 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 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 less than 5 percent. But, with service charge increases equal to 2.5 percent of average balances, thrifts and credit unions stand to improve their earnings by as much as 10 percent.

I hasten to underscore that these projections represent what amounts to a worst-case scenario, with many of the assumptions upon which they are based deemed unlikely by our staff. Moreover, even though the Board of Governors' estimate of a 5 to 6 percent decline in earnings is conservative and reasonable compared to other studies, I do not concur with their judgment that this would pose a serious threat to safety and soundness. A 5 percent decline in individual banks is not disastrous unless prolonged. The Board of Governors' study indicates that earnings declines will diminish after a transition period. I believe that the transition period may be a short one indeed. The experience in New England has provided a great deal of information which should prove valuable in helping other institutions around the country to phase in NOW accounts with minimal disruptive effects.

At least one financial institution feels that this would be the case. Seafirst Corporation, a Seattle, Washington bank holding company, in its June 30, 1977, quarterly report to shareholders stated that:

> We have been tracking NOW account developments since they were started in New England. For the past year we've had a task force working on NOW accounts to prepare ourselves. Knowledge of costs of these types of accounts is the key to adequate pricing for the service. We know our costs and will price them to make a profit. We are in the consumer business in our state heavily and have been for a long time. We are undoubtedly better situated to handle NOW accounts in

> whichever form they may come and they should not have a negative impact on Seafirst. The worst case assessment showed that NOW account introduction would put only a small dent in the growth of earnings in the first year after introduction.

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 proposal to expand NOW account authority nationwide. I do, however, have certain reservations and questions regarding specific provisions of Title I of S. 2055 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. 2055 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 who would serve as chairman, 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 conclusions suggested by available data, I do not 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 it should set the rate as was proposed in S. 1873 or set forth a schedule of rates moving quickly to the commercial bank passbook savings ceiling rate. 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 as adjusted by the inclusion of the National Credit Union Administration in Section 104(e) of S. 2055. I would also recommend that the Comptroller of the Currency be included. 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 banks with primacy in a rate setting mechanism which affects more than 35,000 depository institutions varying greatly in size and powers.

However, should the Congress feel that a special committee must be established for the sole purpose of setting interest rate ceilings on NOW accounts, I would recommend three changes. First, the Comptroller of the Currency should be included as a fifth member of the committee. Second, with five members on the committee, it would be unlikely that the committee would be unable to agree on a rate within the six-month time period; hence, the provision permitting the Board of Governors to set the rate in the event of deadlock would be unnecessary. Third, as I have already said, there is no compelling reason why the Federal Reserve System should be given primacy for setting the rates on NOW accounts. Therefore, I would prefer the chairmanship of this special committee to rotate among the five members.

The Grandfathering Provision

Section 104(b) of S. 2055 grandfathers those financial institutions which are presently authorized to offer NOW accounts or share draft accounts. While I have no objections to this provision as drafted, it should be noted that there would be no need for this provision if the transition period were eliminated or if the present rules applied to those institutions already authorized to offer NOW accounts and share draft accounts were simply extended to all institutions.

The Definition of NOW Accounts and Enforcement Mechanism

Section 101(c) of S. 2055 defines the term "negotiable order of withdrawal account" as:

> ...a depositor 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 a letter to the President of the Senate in June, 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 preferable to one which would automatically subject those facilities to the regulatory and definitional constraints of the Act.

Section 103 of S. 2055 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.

In my opinion, the Comptroller of the Currency should also be included in Section 103. 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. 2055 involves 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, devised in large part because of Federal Reserve concern with membership attrition from the System, would also allow the Federal Reserve to use 5 percent of its income in a given year to pay interest on required reserves, including reserves which must be kept on NOW accounts, and would allow the Federal Reserve to lower member bank reserve requirements on the first $15 million of demand deposits, and on the first $15 million of the combined total of savings deposits and time deposits with maturities exceeding 180 days. 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, in my judgment, related to permitting interest bearing NOW accounts on a national basis. It, therefore, seems preferable to me that these issues be separated from S. 2055 and be subjected to more thorough study.

For the most part, these proposals grow 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. Although the erosion of Federal Reserve membership does have an impact on the role of the Federal Reserve as a supervisor of banks, most independent observers argue that the decline in membership does not have a significant impact on monetary policy.

Nevertheless, 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 reserve structure of the Federal Reserve, 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 holding the proportion of the money supply that they do now.

There have been two major statistical 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 the reserve requirements of the Federal Reserve. 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 statistical 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 could 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. 2055 covers that point by requiring that all banks offering NOW accounts submit reports to the Federal Reserve on deposit liabilities. 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 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, went into effect in the first week of July. A sample of 580 nonmember banks is reporting 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 data from the two projects mentioned will enable them to achieve significant improvements in their estimates of 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 also important. 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. Many 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 noninterest earning deposits at a Federal Reserve Bank. Because 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 because membership in the Federal Reserve is voluntary, and because 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 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. However, 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 need for 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. Our staff estimates that the imposition of the maximum reserve requirement of 12 percent on NOW balances of nonmembers, as permitted under Title II, would increase by less than 2 percent the amount of commercial bank deposits which are subject to Federal Reserve requirements after the first few years of nationwide NOW account privileges. It is doubtful that this relatively small increase in deposits subject to direct Federal Reserve influence could significantly affect monetary control.

Nevertheless, 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. Extension of Regulation Q Authority

Title III of S. 2055 would extend to December 15, 1979, the flexible authority to impose interest rate ceilings on deposits. Secretary Blumenthal in his letter to the President of the Senate in June 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 as soon possible.

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 some 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 burden-some costs on depository institutions -- costs which inevitably work to the detriment of the consumer as well as the banker. One particularly note-worthy 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 Arkansas and Tennessee usury laws have imposed profound restraints on banks and, in the minds of many, was 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 consumers and financial institutions alike.

IV. Federal Chartering Option for Mutual Savings Banks

Title IV of S. 2055 provides a federal chartering option for mutual savings banks. I strongly favor immediate adoption of legislation which would provide that option.

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. While S. 2055 imposes such limitations, the Financial Reform Act of 1976 did not. I prefer the approach taken in that bill. 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 regulatory agency 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.

I wish to reiterate, however, my support for the federal chartering option for mutual savings banks and urge that the problems I have just mentioned be resolved expeditiously and not serve as a reason for delay in adopting this long overdue measure.

V. Extension of Deposit Insurance

Title VI of S. 2055 increases the deposit insurance limitation on IRA and Keogh accounts to $100,000 in commercial banks, mutual savings banks, savings and loan associations and federal credit unions. I have no objection to this provision. In fact, I think a strong argument can be made that increased insurance is desirable for IRA and Keogh accounts because they serve as a substitute for pension funds and an individual should not have to worry about the safety of funds being saved for his use in retirement.

In conclusion, I would simply reiterate that we at the FDIC stand ready to assist you and your staff in whatever fashion you deem appropriate.

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