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Federal Reserve Requirements Act of 1978 (S. 3304)

Presented to

Senate Committee on Banking, Housing, and Urban Affairs
United States Senate

by

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George A. LeMaistre, Chairman
Federal Deposit Insurance Corporation

August 14, 1978

Mr. Chairman, I appreciate the opportunity to testify before this Committee and present the FDIC's views on the Federal Reserve Requirements Act of 1978 (S. 3304) which would amend the Federal Reserve Act to provide for the maintenance of reserves by certain depository institutions, to require the Federal Reserve System to impose charges for its services, and to authorize the payment of interest on reserves held in Federal Reserve banks.

This bill and several under consideration by the House Committee on Banking, Finance, and Urban Affairs would deal with attrition in Federal Reserve System membership and related matters. There has been a slow but steady erosion of Federal Reserve membership over the last decade as banks have chosen to leave the System. Recently, this gradual decline accelerated. Since the beginning of 1977, 108 banks have withdrawn from membership. The percentage of total deposits of commercial banks held by Federal Reserve members has decreased from 83 percent in 1965 to nearly 73 percent at the present time.

The Federal Reserve System has become increasingly concerned about the attrition of membership and the declining proportion of deposits held by member banks. For many years it proposed mandatory membership as a solution. The proposal never received a serious hearing in the Congress for various reasons, primarily because of the concern expressed by the States about the impact of mandatory membership on the viability of State banking systems. More recently, the Federal Reserve modified its proposal to provide for mandatory reserves and membership privileges for nonmembers.

Last year, as the problem of membership attrition became more acute, the System proposed payment of interest on required reserves and reductions in the minimum statutory reserve requirement limitations. Those proposals were coupled with the Consumer Financial Services Act (S. 2055) which would have authorized depository institutions to offer NOW accounts. In my testimony on this subject before the Subcommittee on Financial Institutions last year, I stated that payment of interest on required reserves and reduction of reserve requirements would have important implications for the competitive balance between member and nonmember banks and for the structure of the banking system. I indicated that, in my judgment, these issues are quite complex and are not related to permitting interest bearing NOW accounts on a national basis. Therefore, I recommended that these issues be dealt with separately and be subjected to careful and reasoned study. These hearings and those recently held before the House Committee on Banking, Finance and Urban Affairs provide the opportunity for the thorough consideration I think is essential.

Let me begin by stating our view that the legal requirement that Federal Reserve member banks maintain sterile reserves is inequitable to them and inequitable to their customers. In many States, it also places member banks at a competitive disadvantage vis-a-vis nonmember banks. The bill under discussion proposes: (1) to establish universal reserve requirements for all banks or depository institutions; (2) to pay interest on reserves and to reduce reserve requirements; and (3) to charge banks for Federal Reserve services now provided free to member banks.

For reasons I shall discuss, we strongly oppose the establishment of universal reserve requirements for all commercial banks as well as all depository institutions. The payment of interest on reserves and pricing of services, however, are attractive and deserve thoughtful and sympathetic consideration. The implementation would not be easy because a redressing of the imbalance between member and nonmember banks raises many of the difficult issues with which the Congress has been wrestling, without resolution, for a number of years. These include, notably, the issue of changes in the Federal regulatory structure, particularly whether the Federal Reserve should continue to exercise supervisory authority; and the issue of regulatory reform, particularly whether interest rate ceilings and the prohibition of interest on demand deposits should be abolished.

In the remainder of this statement I shall explain how we reached these conclusions by discussing how the proposals for dealing with the attrition of Federal Reserve membership bear on several important public policy considerations: (1) the capability of the Federal Reserve System to conduct monetary policy effectively, (2) the balance between the State and national banking systems, (3) the efficiency and innovative capacity of the banking system, and (4) the viability of the banking system under liquidity pressures.

I. Monetary Policy Effectiveness

The Federal Reserve has stated its belief that the decline in the proportion of deposits held by member banks caused by membership attrition adversely affects the precision with which monetary policy can be conducted. The point is that as a larger portion of deposits becomes subject to diverse State reserve requirements the linkage between bank reserves and the money supply becomes less predictable.

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 subject to universal reserve requirements or if all banks were member banks. Under the present reserve structure of the Federal Reserve, time deposits are subject to different requirements than demand deposits and different size 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 depository institutions are involved. It should be noted that S. 3304 would not alter this appreciably, because it would maintain the present system of different percentages of deposits set aside as reserves based on bank size.

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.

Two major statistical studies have attempted to ascertain the impact of universal reserve requirements for member and 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 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 there would have been even greater variations in the money stock. Starleaf thus rejected the argument that equal Federal Reserve reserve requirements for member and nonmember banks are necessary for the implementation of monetary policy.

There have also been a number of attempts 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 different manner from member banks and that such behavior thwarts implementation of Federal Reserve monetary policy. They concluded that these arguments have no validity. A study conducted by Gary Gilbert and Manfred Peterson at the FDIC found results similar to those of Robertson and Phillips.

Most economists regard reserve requirements as secondary to open market operations in conducting monetary policy. The Federal Reserve has made minimal use of changes in reserve requirements in recent years, possibly owing to its fear of aggravating the membership attrition

problem. Nonetheless, the limited use of this monetary tool has not had a noticeable impact on the ability of the Federal Reserve to conduct monetary policy.

Furthermore, several studies have shown that open market operations have a timely impact on all commercial bank reserves. These studies indicate that the total impact is felt by banks in some regions within the first 2 weeks following open market operations. In most cases, the impact of open market operations on reserves is completely transmitted within 6 weeks. Moreover, the length of time for the impact of open market operations to be transmitted is not related to the region's distance from money market centers.

What the Federal Reserve does need to conduct monetary policy effectively is information about monetary aggregates. For the conduct of monetary policy, the Federal Reserve should be permitted to obtain summary statistics on assets and liabilities of all depository institution from the appropriate Federal agency. S. 3304 would require depository institutions to report their deposit liabilities and required reserves directly to the Federal Reserve. We support making such information available to the Federal Reserve and have no objection to the adoption of the proposal in S. 3304.

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 were 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 for Reports of Condition.

A second step, also recommended by the Bach Committee, went into effect in the first week of July 1977. A sample of 580 non-member banks is reporting deposit and cash items on a regular weekly basis, the same items as all nonmember banks report four times a year. The Federal Reserve has indicated that it expects the data from these two surveys to permit significant improvements in their estimates of the nonmember bank component of the Nation's money supply. The FDIC and the Federal Reserve have agreed to review this program in mid-1979 to determine whether nonmember bank data are necessary for monetary policy purposes and, if they are, whether the sample of nonmember banks is adequate. In the interest of improving the timeliness of the survey data to the Federal Reserve, the FDIC intends to request the 580 banks participating in the program to submit the data directly to the Federal Reserve rather than through the FDIC regional offices, which is the present procedure.

In summary, we believe the need for legal reserve requirements for monetary control purposes is not supported by the weight of available evidence. The evidence to date suggests that monetary policy effectiveness depends on adequate data, proper estimation procedures, and appropriate open market operations decisions; and not on reserve requirement jurisdiction.

Bank Supervision and the Exercise of Monetary Policy

Representatives of the Federal Reserve System have also argued that significant supervisory and regulatory responsibilities are

required for the effective conduct of monetary policy. In his testimony before the House Banking Committee, Chairman Miller reiterated the Federal Reserve's belief that its activities in the bank supervisory and regulatory area "cannot be readily separated from its job of conducting monetary policy." In the past, representatives of the Federal Reserve have argued as well that an understanding of the nuances of monetary policy and of developments in the economy facilitate bank supervision.

We feel there are two valid arguments why bank supervision and regulation and the conduct of monetary policy should be separated. First, it has been argued that the Federal Reserve's responsibility for bank supervision diverts attention from monetary policy formation and that this diversion may reduce its effectiveness in implementing monetary policy. Second, when the implementation of monetary policy goals and bank supervision are combined, the former will inevitably take precedence leading to inconsistent and inequitable bank supervision.

We believe some benefits will be gained from the functional separation of supervision and monetary policy. Furthermore, it is our opinion that the attrition of members from the Federal Reserve System and, hence, a lessening of its supervisory and regulatory presence has not interfered with the effective conduct of monetary policy. Based on the available evidence and experience, we tentatively conclude that neither control of reserve requirements in nonmember depository institutions nor supervisory jurisdiction is critical to the conduct of monetary policy.

II. Dual Banking System

Historically, our Nation's banking system has developed within the unique Federal character of our State and national governments. Today this is manifested in the ability of both the States and the Federal Government to charter banks and other kinds of depository institutions. The vitality of this dualism is maintained by permitting banks to convert from one chartering authority to another.

While some may disagree, we believe the dual system of State and national banks has been a positive element in the American system of government and has contributed to a more innovative and responsive financial system. Accordingly, maintaining a balance between the State and national banking systems is a desirable public policy. The attrition in Federal Reserve membership gives some credence to the argument that this balance is tilting toward the State systems. However, despite the decline of Federal Reserve membership, member banks still hold about three-quarters of domestic deposits. Moreover, the largest banks which depend on Federal Reserve clearing and money transfer services represent a hard core of membership and deposits not likely to leave the System.

Nonetheless, we should not maintain a "balance" for the sake of balance. It is clear that reserve requirements of the Federal Reserve weigh heavily on member banks and result generally in such banks carrying more cash than they otherwise would. In direct competition with the nonmember bank, a member bank might be disadvantaged.

One solution to the problem of equity that we believe should be resisted is the proposal in S. 3304 to impose universal reserve requirements on the transactions balances of nonmember depository institutions. As we explained above, extension of universal reserve

requirements to nonmember institutions is not essential to conduct monetary policy effectively. While reserve requirements are primarily responsible for the inequity of Federal Reserve membership, we believe that equity can be achieved in other ways--such as paying interest on reserves, permitting reserves to be held in the form of marketable securities, or reducing reserve requirements--without the necessity of resorting to universal reserves for all institutions.

Universal reserve requirements are perceived as a threat to the integrity of State banking systems. If nonmember banks have to maintain reserves at the Federal Reserve just as member banks must do, but have no access or have limited access to the discount window and other System benefits, why not become members? The assumption is that obligatory universal reserves would not only make nonmembership unattractive, but many institutions would also be inclined to convert to a national charter. The result would be an imbalance in the dual system in favor of membership and the national banking system.

We do not know whether this would occur. However, such a proposal should not be accepted unless this danger is eliminated. If there were a massive influx into the State member and national systems, many State systems would lose their viability, and the supervisory authority of the Federal Reserve and the Comptroller of the Currency would grow substantially without the benefit of Congressional consideration. My point is that the issue of Federal regulatory structure cannot be isolated from this issue of balance. The better of the two proposals--the payment of interest on reserves and lowering of reserve requirements--avoids some serious shortcomings of the universal reserve requirements proposal, but it raises the possibility of weakening the State systems.

In summary, we cannot prove that universal reserve requirements would seriously damage the dual banking system. However, we feel this portion of S. 3304 should be eliminated unless sufficient safeguards for maintaining a balance in the dual banking system are developed.

III. Banking System Efficiency and Innovativeness

Market pricing of goods and services is vital to the efficient allocation and use of those goods and services. In the words of Milton Friedman, pricing is highly desirable "...to prevent the waste that arises from the absence of specific charges for them." Generally, market pricing encourages competition to improve the quality of goods and services and to lower their cost. Presently, pricing is absent in at least three areas that bear directly or indirectly upon the legislation under consideration: (1) the absence of interest payment on the required reserves of member banks, (2) the provision of services by the Federal Reserve to member banks, and (3) the prohibition of interest payments on demand deposit balances and deposit interest rate ceilings. I will address each in turn.

Interest on Reserves

As a matter of principle, whether to pay interest on reserves should not be an issue. Presently, failure to pay interest is tantamount to the imposition of a tax without calling it that. A substantial amount of the revenue foregone by member banks is passed on to the Treasury Department by the Federal Reserve. Some of the revenue is used by the System to offset the cost of providing "free" services to member banks. If it were the national policy to tax banks, it would be preferable to levy the tax directly on all

banks and other depository institutions as well. Then all would be treated equally.

Concern has been raised about the adverse impact payment of interest on reserves would have on Treasury revenues. This concern has led to attempts to structure a procedure for paying interest while minimizing the loss in Treasury revenues. However, structuring a procedure for paying interest bogs down in questions about the appropriate interest rate, concerns about possible windfall gains to large banks, and controversy over what percentage of the Federal Reserve System's revenues should be available for interest payments. We submit that none of this is really necessary. It imposes the subjective judgment of men in dealing with the cost of membership when the market system could probably do better. Why not permit member banks to invest their reserves in interest bearing securities? In fact the percentage of assets held in cash would probably be reduced by only a few percentage points. The Federal Reserve could determine what kinds of securities should be eligible for this purpose based on considerations such as risk. It might even supply them from its portfolio. This approach would permit each bank to make its own choice and obviate the necessity of having the Federal Reserve establish a rate. Presently, 36 States allow State nonmember banks to hold at least part of their required reserves in the form of U.S. Government securities. This issue should be the subject of a careful study as Congressman Stanton has proposed in H. R. 12706. If either the loss of Treasury revenues or subsidization of small banks were felt to be important problems, we would recommend that the Congress address these problems directly through national tax policy.

To the extent that our faith in the efficacy of the market system might be misplaced, we endorse the provision in Section 3 of H. R. 12706 that would require the Board of Governors to prepare a study on permitting member banks to invest their reserves in securities.

Pricing of Services

Explicitly pricing Federal Reserve services should increase the efficiency of our financial system by allowing various financial institutions to purchase the services they desire from the Federal Reserve or private alternatives. Among the Federal Reserve System's major services are: operation of the payments system, including check processing and transportation and automated clearinghouse services; pickup and delivery of coin and currency; wire transfers; purchase, sale, safekeeping and clearing securities; and operation of the discount window.

If interest were paid on member bank reserves, by whatever means, pricing of Federal Reserve services would be essential to prevent discriminatory treatment of nonmember depository institutions. Pricing of services also is sound policy because it would enhance the efficiency of the financial system. This would provide a better opportunity for the correspondent banking system to compete with the Federal Reserve. Such competition, in turn, should encourage the Federal Reserve to eliminate waste, to improve services and to offer new ones.

Assuming that it is good public policy to maintain a significant presence for the Federal Reserve in the payments mechanism, we feel that the Federal Reserve should have some flexibility in setting prices. The requirement that pricing principles be produced and published at least a year before the fee schedule becomes effective

assures that the Federal Reserve will not take advantage of its unique position. In developing a set of principles, we would hope that consideration would be given to some of the following matters so that further Congressional action will not be necessary.

The costs of producing the same service for a variety of customers may differ in various areas of the country because labor and capital costs are not equal. Thus, it may be more efficient for the Federal Reserve to charge different prices according to the costs of providing services to different customers. The cost of providing a certain service to nonmember banks and nonbank depository institutions could be below the cost of providing the same service only to member banks. This could result from the way in which a service were utilized. For example, a credit union may not require daily pickup and delivery of coins or currency, or a savings and loan association might not complete security transactions as often as a commercial bank.

To allow the Federal Reserve some flexibility in developing and implementing a pricing system, the Federal Reserve should be permitted to price services explicitly by broad service classes. One price schedule might be developed for payments services, another for securities services, and another for transportation. Perhaps a cost-plus pricing system could be developed for the services now provided by the Federal Reserve, and the markup over the cost of providing the service might be limited to a fixed percentage.

There seem to be economies of scale associated with at least some services that the Federal Reserve now provides. If these economies are pervasive, the Federal Reserve will be able to offer the relevant service at a lower price than any private competitor. There is nothing undesirable about this, but the result should be determined by experi-

ence, not fiat. It is not unlikely that the Federal Reserve has a natural monopoly on some services because private competitors could not attract sufficient volume to offer the same services at as low a price.

According to materials that former Federal Reserve Chairman Burns submitted to Senator Proxmire on October 4, 1977, in recent years the per unit costs of conventional check processing, return items, transfer of funds, and automated clearinghouse activities have declined as volumes increased. If these trends continue, the private sector might not be able to offer competing services at costs that are as low as those incurred by the Federal Reserve. On the other hand, the cash services offered by the Federal Reserve do not seem to show declining costs with increasing volumes. In an electronic banking environment, it is not clear that several payments systems can compete efficiently. However, in this regard we point out that the private bank wire continues to compete with the Federal Reserve wire, and networks of correspondent banks provide payment services that are preferred by some member banks over Federal Reserve payment services.

Interest on Demand Deposits

Payment of interest on reserves of member banks potentially could place nonmember banks at a disadvantage because the 40-year old prohibition against the payment of interest on demand deposits does not permit member banks to pay interest on correspondent balances. These balances often serve as reserves for nonmember banks and serve as well for check clearing operations and compensation for other correspondent services. If the principle of explicit pricing is adopted for member banks, then parallel treatment would dictate that banks should have the choice of paying interest on correspondent

balances and levying explicit charges for correspondent services. There can be little doubt that this would increase the efficiency of the financial system.

As a matter of principle, if the interest prohibition is lifted for correspondent deposits, it should be lifted for all demand deposits. I have long supported elimination of the prohibition of interest payments on all transactions balances as well as removal of interest rate ceilings on other kinds of deposits. 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 our 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 travelers' 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 competition with other institutions for accounts or a depositor might choose to forego such services and spend interest income on different goods and services. This is an important benefit--consumers would decide 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 for customers to transfer funds from non-interest bearing checking accounts to savings accounts. Thus depositors will no longer find it necessary to maintain separate checking and savings accounts. Customers will not need to spend as much time and effort in managing deposit balances, particularly when interest rates are high. Also, existing inequities whereby some depositors pay less than the cost of servicing their accounts will be eliminated.

IV. Banking System Viability and Liquidity Pressures

One of the important functions of the Federal Reserve System is to serve as the Nation's lender of last resort. Through the vehicle of the discount window, the Federal Reserve is able to provide liquidity when it is needed. The discount window acts as a safety valve by permitting the Federal Reserve to cushion the impact of a tight monetary policy on individual institutions. It can also assist member banks in meeting routine but unexpected loan demand or deposit withdrawals, seasonal liquidity requirements, and emergency liquidity needs. A member bank's first recourse is

expected to be to the market. If sufficient funds are not available in the market, the Reserve Bank might provide accommodation, but it is understood that it is temporary. Each member bank must eliminate its discount window borrowings within a reasonable period. Reserve Banks also require member banks to pledge collateral, typically of high quality.

The Federal Reserve Act authorizes entities other than member banks to use the discount window only under "unusual and exigent" circumstances. As a result, Federal Reserve reports indicate that no nonmember bank has borrowed from the discount window since 1966.

While nonmember banks also face unexpected needs for liquidity, they ordinarily cope with them with little difficulty by borrowing from correspondent banks in much the same way that members do from the Federal Reserve. Indeed, even when nonmember banks are in trouble, it is generally possible for them to borrow from correspondents if they have sufficient and acceptable collateral. To be sure, the lending bank may also impose special conditions on the borrowing bank. But in that regard, the Federal Reserve also behaves like a careful creditor in accommodating a floundering bank. It makes sure such loans are well collateralized, that its interest in the collateral is perfected, and that the borrowing bank is solvent. Thus, the fact that nonmembers do not have window accommodation is not seriously disadvantageous in most circumstances.

The Federal Reserve believes that the ability of the financial system to handle liquidity "crunches" will weaken if membership attrition continues unabated. It should be understood that the decline in Federal Reserve membership does not impair the ability of the System to cope with the kind of generalized liquidity crisis most

of us are concerned about, in which the public demands more cash than the banking system holds. Aggressive open market operations and discount window accommodation to members can provide cash sufficient to meet the public's demand. The decline in membership does impair the ability of the system to minister to a localized liquidity squeeze involving one or a few institutions. In the past, the Federal Reserve has sometimes resorted to conduit loans in such circumstances--that is, loans to a member bank which in turn provide credit to a nonmember institution. We think that the Federal Reserve should accommodate a nonmember bank directly in such special circumstances.

Indeed, we are concerned that membership attrition has contributed to a narrow interpretation of the words "unusual and exigent" by the Federal Reserve. If experience is a guide, these words appear to be interpreted by the Board of Governors as requiring a national emergency before a Reserve Bank would be authorized to lend to a nonmember institution. The interpretation could be less restrictive, but at the present time it does not appear that the Board of Governors is willing to interpret "unusual and exigent" circumstances as extending to situations that are unique to an individual nonmember institution. The unwillingness of the Federal Reserve to open the discount window to American Bank and Trust of Orangeburg, South Carolina, in September 1974 led the FDIC to take the unusual step of providing short-term liquidity directly to the bank under Section 13(c) of the FDI Act.*

In December 1975, former FDIC Chairman Frank Wille proposed that the Federal Reserve make short-term, temporary loans available to nonmember banks in such circumstances. We support Chairman Wille's

*Two weeks later the bank was closed.

proposal. We believe that emergency borrowings from the Federal Reserve discount window should be available to member and non-member banks alike upon certification by the FDIC that they are in danger of failing and that such assistance is necessary for a temporary period until a merger, a receivership sale, or some other orderly resolution of the bank's problems is arranged. The FDIC, in turn, should be authorized to guarantee the repayment of such borrowings out of the resources of the deposit insurance fund. In connection with this authority, the FDIC should be required by law to keep the Federal Reserve fully informed with up-to-date information as to the financial condition of all banks certified to borrow from the discount window under this provision.