FDIC
FEDERAL DEPOSIT INSURANCE CORPORATION

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Statement on

S. 85, the "Monetary Policy Improvement Act of 1979"

and

S. 353, the "Federal Reserve Modernization Act of 1979"

Presented to

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

by

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Mr. Chairman, I appreciate this opportunity to testify on this question of Federal Reserve membership.

We in the FDIC share with our partner agency its concern about the steady decline in membership, particularly with regard to its effect on the conduct of monetary policy.

This committee has a number of proposals before it to deal with this matter. I believe that any solution should incorporate the following elements:

1. The Federal Reserve should have the tools it needs to conduct monetary policy.

2. The Treasury should suffer minimal loss of revenue as a result of this legislative initiative.

3. All similarly situated deposit accounts should be treated alike, regardless of the type of financial institution.

4. Membership in the Federal Reserve System should remain voluntary, but reserves should be made mandatory for institutions designated under this legislation.

5. All depository-type institutions should have a lender of last resort.

6. The Federal Reserve should be relieved of the burden of bank supervision, especially in view of the additional workload that a substantial transfer of state banks to Federal Reserve membership would entail, and the federal supervisory function of state banks should be consolidated within the FDIC.

MONETARY POLICY

I want to say at the outset that we feel that the Federal Reserve should have the tools it needs for the successful conduct of the nation's monetary policy. That prime function of the nation's central bank is critical to the nation's economy, to the well being of our people here at home, and to the maintenance of the value of the dollar in international exchange. To the extent that the Federal Reserve is handicapped in its exercise of monetary management, the nation runs a greater risk of runaway inflation or devastating depression.

The FDIC has long supported the Federal Reserve in its monetary policy function by supplying necessary financial information on the banks we supervise, an estimated 8,827 state banks which are not members of the Federal Reserve System. In recent years, in response to requests from our partner agency, we stepped up the flow of information.

In early 1976 the FDIC instituted a quarterly survey of all 8,827 nonmember banks in order to provide the Federal Reserve with better information on the money supply. Then in July of 1977, a sample of 580 nonmember banks began reporting deposits and cash items on a regular weekly basis, the same items as all nonmember banks report quarterly. The Federal Reserve has indicated that it expects the data from these two surveys to significantly improve its estimates of the nonmember bank component of the nation's money supply. Just this past week, the Federal Reserve has asked us, and we have agreed, to continue the surveys for the time being. The FDIC and the Federal

Reserve have agreed to review these programs in the very near future to determine how important nonmember bank data are for monetary policy purposes and whether the sample of nonmember banks is adequate.

Traditionally, the Federal Reserve has employed open market operations and the adjustment of reserve requirements as its two major levers in administering monetary policy. Now the Federal Reserve is concerned that the erosion in its membership is seriously undermining one of its two principal controls of monetary policy.

The Federal Reserve further contends that reserve levels serve as a benchmark against which open market operations can be gauged and that the effectiveness of such operations is impaired as reserve coverage shrinks.

There is no question that the drop in membership has been substantial. The Federal Reserve has estimated that the proportion of commercial bank demand deposits subject to reserve requirements has declined from 86 percent in 1960 to 72 percent in mid-1978. The Federal Reserve estimates that this is about the minimum level at which reserves can be an effective implement in conducting monetary policy. Further, we can anticipate a substantial increase in the rate of membership withdrawals, especially if no action is taken legislatively

WHY THE DECLINE

It is not difficult to understand the reason for the steady decline of Federal Reserve member banks. Reserve requirements which cannot earn interest have always constituted a burden

on members. In fact, a staff study by the Federal Reserve estimates that this cost of belonging to the system exceeds $650 million annually, based on 1977 figures. That would be about 9 percent of profits of member banks before income taxes.

If that were not reason enough for member banks to chafe under the burden, the situation is made worse by the fierce and steadily increasing competition of thrift industries. For example, commercial banks, which once held a virtual monopoly on check writing services, are now subject to such competition as interest-bearing NOW accounts, credit union share drafts, and a variety of transaction services which permit patrons to transfer funds from savings or other interest-earning accounts.

We can see similar competition for non-demand deposits from thrifts and a growing number of non-bank industries which are bidding for new sources of funds. The distinction not only among financial institutions, but also between such institutions and the business world at large, is becoming increasingly blurred.

Federal Reserve member banks resent the fact that while they continue to be required to hold non-income producing reserves, they must now contend with a new wave of financial services competition from institutions which have no such reserve requirements.

The upshot of all this has been mounting pressure to alleviate the Federal Reserve membership problem. Your committee gave this matter intensive consideration at the end of the 95th Congress, but there was not time for Congress to act. Since then, both your committee and the Federal Reserve have given the matter more study and refined proposals.

Two of the most important are before you today -- S. 85, the Monetary Policy Improvement Act of 1979, and S. 353, the Federal Reserve Modernization Act of 1979. There are any number of other proposals, and variations on proposals, as to the best way of stemming the ebb of Federal membership.

MEMBERSHIP PROPOSALS

Most proposals before your committee recommend reductions in reserve requirements so that institutions would have additional funds for investment or other earnings purposes. We would support this and would add that the reduction should be substantial. This, combined with the requirement for reserves at similarly situated institutions, would, in effect, broaden the reserve base, but lower the amounts of the reserves so that the burden is not too onerous for any one institution and is more equitably shared by all institutions.

I believe that two precepts should be incorporated into whatever membership course this committee ultimately chooses:

First, membership in the Federal Reserve System should continue to be voluntary, but the reserve requirement should be made mandatory for institutions designated under this legislation.

Second, all financial institutions equally situated should be subject to the same restrictions, i.e., reserve requirements should be applied alike on a uniform basis to all types of financial institutions offering the kinds of services against which reserves must be held.

There are proposals for exemptions for small banks, and I would support an exemption of whatever size the committee feels appropriate, provided that it meets the standard of treating equally situated financial institutions alike.

Your committee at this time may also want to consider a simplification of the reserve structure. Under the present system, time deposits are subject to different requirements than demand deposits, and different size classes of member banks are subject to varying reserve requirements. Reserves on demand deposits now range from seven percent to sixteen and a quarter precent, depending on the status and size of the bank, and between one and six percent on savings deposits. As deposits are switched among member banks of different sizes and between demand and savings accounts, the effective reserve requirement changes. This makes it difficult to calculate the effect on money supply of a given change in reserves. The problem increases as new developments, such as telephone transfers and NOW accounts and automatic transfer from savings to checking accounts which took effect last November 1, make it much easier for customers to shift funds between demand and savings deposits.

LENDER OF LAST RESORT

Let us now take a look at aspects of this problem that are of particular interest to the FDIC as the insurer of most of the nation's banks.

Since the inception of the Federal Reserve System, its lender-of-last-resort function has been one of the most important benefits of bank membership. The so-called discount window is essential to the smooth functioning of our banking system. Member banks can turn to it for prompt assistance in meeting unexpectedly heavy obligations or in coping with the effect of restrictive monetary and credit policy. It is a convenient and indispensable cash-flow bridge.

But as the Federal Reserve itself points out, the effectiveness of the discount window, which is available only to member banks, declines in step with the decline in bank membership. To that extent, the decline in membership makes more likely the possibility of a crisis in banks caught in a monetary cash-flow squeeze.

Virtually all proposals before your committee would broaden access to the discount window. We believe that all depository-type institutions should have a lender of last resort. As part of this package, a universal access to the discount window would provide a vital back-up support to the vast majority of the nation's banks which are now closed out of the Federal Reserve's window.

MINIMAL LOSS TO THE TREASURY

This brings us generally to the question of cost to the Treasury of the various Federal Reserve membership proposals. This is very much a question of imponderables. It is difficult to guage the effect of any action on membership under a voluntary system. Another consideration is that any direct loss to

the Treasury in terms of transfers from the Federal Reserve is partly recapturable in the form of taxes on new earnings potential of banks and bank stockholders.

The Treasury Department has voiced concern about the cost of this legislation and has suggested a dollar figure on Treasury net loss above which Treasury Department support for this legislation would be withdrawn.

My hope would be that through the appropriate combination of reduced but broader-based reserves and charges for Federal Reserve services, we could compensate for loss to the Treasury to a major degree and thus avoid transferring the present cost from the banks to the general taxpayer.

EXPLICIT PRICING OF FEDERAL RESERVE SERVICES

The nation is well served by a massive collection and payments system that safely and surely handles the clearing of millions of transactions every day. The process takes place within the Federal Reserve System as a benefit of membership and outside the System in major correspondent banks that provide similar services for nonmember banks. We want to assure that our collection and payments system remains as risk-free and effective as it is today.

Several proposals would seek to offset the cost to the Treasury of Federal Reserve membership revision by charging for Federal Reserve services, pricing them individually, and perhaps making some of them available to nonmember institutions.

This would allow 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 payment system, including check processing and transportation and automated clearinghouse functions; pick up and delivery of coin and currency; wire transfers; purchase, sale, safekeeping and clearing of securities; and operation of the discount window.

The effect of explicit pricing would be to provide a better opportunity for competition from those correspondent banking systems that provide payments and other clearinghouse functions outside the Federal Reserve System.

The Federal Reserve has circulated a tentative pricing schedule but has considered the separate-pricing feature a part of the entire membership package.

S. 85 provides guidelines to assure that the competition is fair. Federal Reserve prices would be required to take into account all direct and indirect costs plus an adjustment for taxes and a payout to stockholders that would be required of private firms. S. 85 also requires that pricing give due regard to competitive factors and to the provision of an adequate level of services nationwide.

We would certainly support that. We must preserve and strengthen the risk-free collection system that has developed within and without the Federal Reserve System. Fair competition and explicit pricing should be designed to nurture that dual enterprise and to encourage the growth and development of safe, reliable services to the banking public at minimum cost.

TRANSFER OF BANK SUPERVISORY FUNCTION

One of the unintended and undesirable side effects of this legislation could be a rapid burgeoning in the bank supervisory workload of the Federal Reserve. If reserves are made mandatory, a substantial transfer of state banks to Federal Reserve membership could follow. This would be almost a certainty if discount window access were to continue to be limited to members. The FDIC now supervises 8,827 state banks that are not members of the Federal Reserve System; if many of these were suddenly to join the System, the Federal Reserve, which now supervises about 1,000 banks, could easily find itself with a massive increase in its bank supervisory workload.

This additional responsibility would only further detract from the Federal Reserve's primary concern of conducting monetary policy. Such an occurrence would be most unfortunate because these functions -- monetary policy and bank supervision -- are each important enough in their own right to merit and demand the full time attention of a single agency.

Therefore, we would recommend that as an essential part of this legislation the entire federal supervisory function for state banks, regardless of Federal Reserve membership, be consolidated within the FDIC. This would provide economy in operations and would be a major move toward more uniform supervision.

We continue to recognize the legitimate need of the Federal Reserve for financial information on state bank operations, and

under any circumstances we will continue to work with the Federal Reserve and to provide this information as we always have in the past. We will continue to fulfill our responsibility to cooperate with its conduct of monetary policy.

The proposals I have outlined will strengthen the dual banking system, support monetary policy objectives of the Federal Reserve, be fair to all segments of the banking industry and foster the continued safety and soundness of our banking system.