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Statement by

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Vice Chairman, Board of Governors of the Federal Reserve System

before the

Subcommittee on Domestic Monetary Policy

of the

Committee on Banking, Finance and Urban Affairs

U.S. House of Representatives

June 16, 1982

I am pleased to appear before this Committee on behalf of the Federal Reserve Board to discuss H.R. 6222. This amendment to the Federal Reserve Act would exempt from reserve requirements the first $2 million of reservable liabilities at all depository institutions. On several occasions, the Federal Reserve has expressed support for legislation that would permanently reduce the relatively heavy burden of reserve requirements on the smallest institutions. This bill accomplishes that objective, thereby fostering competitive balance among depository institutions. However, granting an exemption on reservable liabilities to all depository instututions would impair the Federal Reserve's ability to control the monetary aggregates if the level of the initial exemption were higher than $2 million. Accordingly, the Board would find this legislation acceptable so long as the exemption level were not higher than $2 million. Before discussing the specifics of this bill, I will review both the problems involved in the present reserve deferral for smaller institutions and an alternative approach for dealing with this issue.

The Depository Institutions Deregulation and Monetary Control Act of 1980 imposed uniform reserve requirements on all depository institutions, which has aided the conduct of monetary policy and moved in the direction of a more similar regulatory environment for member and nonmember institutions. However, in 1980 the Federal Reserve was concerned that subjecting a large number of institutions all at once to new reporting and reserve maintenance requirements would cause significant operational difficulties and interfere with the orderly implementation of the Act. Therefore, the Board granted a six-month deferral of reporting and reserve requirements to certain depository institutions with total deposits of less than $2 million as of December 31, 1979. This deferral could not apply to member banks, which were already subject to reserve and reporting requirements. In addition, the Board did not apply the deferral of reserve and reporting requirements to Edge Act and Agreement corporations or U.S. agencies and branches of foreign banks that are part of relatively large organizations.

The Board subsequently extended the deferral on three occasions, initially to minimize operational difficulties and later in light of legislation pending before Congress that would permanently exempt smaller institutions from reserve requirements. The current deferral expires on December 31 of this year. In view of the requirements of the Monetary Control Act and the improving capacity of the Federal Reserve to absorb the operational requirements associated with deferred institutions, we believe it would be inappropriate for the Board to grant further extensions indefinitely without legislative action.

As shown in Tables 1 and 2, an estimated 17,700 institutions are not now subject to reserve requirements: 300 nonmember banks, 400 savings and loans, and 17,000 credit unions. Without the present deferral, a sizable proportion would be forced to maintain required reserves. Ending the deferral would substantially increase the overall administrative and operational burden of reserve requirements for these institutions and raise somewhat the operating costs of the Federal Reserve System. But ending the deferral would not perceptibly aid monetary policy. The entire group of institutions not currently subject to reserve requirements, while representing about 44 percent of all depository institutions, has less than one percent of total deposits.

Although the Board recognizes that reserve requirements are necessary for effective monetary control, I would like to emphasize that we are mindful of the reserve burden on all institutions. The Board supports the aim of the Monetary Control Act that all depository institutions share the reserve burden equitably. The earnings forgone by holding noninterest-bearing reserves are proportional to required reserves and hence would be distributed fairly across institutions of different sizes if no institutions were exempt. It should be noted that paying interest on required reserves would equitably offset this burden. However, with no exemption, the administrative and operational costs of compliance would not be distributed equitably, since these burdens fall more heavily on smaller institutions. In light of their relatively heavy burden, the Board supports efforts to exempt smaller institutions permanently from reserve requirements.

The issue before us today is determining the best approach for accomplishing this goal. The Federal Reserve has in the past recommended consideration of two alternative approaches. One approach, exempting institutions below a certain level of total deposits from reserve requirements, was contained in legislation previously introduced in the U.S. Senate. The other approach, which exempts from reserve requirements a certain level of reservable liabilities at all institutions, is embodied in the present bill, H.R. 6222.

Section 211 of the comprehensive banking bill introduced by Senator Garn, S. 1720, reflects the first approach. It would exempt from reserve requirements about 19,900 depository institutions that presently have less than $5 million in total deposits (note the difference from reservable liabilities). These institutions now account for about 1-1/4 percent of total deposits. The $5 million cutoff figure would increase annually by an amount equal to 80 percent of the percentage increase in total deposits at all institutions. In testimony on S. 1720 on October 29, 1981, Chairman Volcker indicated that the Board could support such an amendment, although he noted that the amendment had certain drawbacks and suggested consideration of the second approach contained in the bill under discussion today.

One drawback of the total deposit approach is that when an institution grows above $5 million, it would become subject to reserve requirements not only on deposits above that level but also on its total reservable deposits. To use the jargon of economists, institutions just passing over the threshold confront a very high marginal reserve requirement. In addition, this system contains an inequity because institutions just below the cutoff would be completely exempt from reserve requirements, while slightly larger institutions just above the cutoff would be fully subject to requirements on all their reservable deposits.

The approach in the present bill exempts from reserve requirements the first $2 million in reservable liabilities of all institutions. The number of fully exempt institutions is somewhat larger under this approach than under the total deposit method. Since almost all institutions with $5 million or less in total deposits have no more than $2 million in reservable liabilities, the present bill would fully exempt from reserve requirements roughly 19,750 of the 19,900 institutions with less than $5 million in total deposits. As indicated in Table 1, it would also exempt about 4,100 institutions with more than $5 million in total deposits but less than $2 million in reservable liabilities. In addition, by granting an equal reduction in reserve requirements to all institutions on their first $2 million in reservable liabilities, this method avoids the penalty for deposit growth above the cutoff and treats institutions in the neighborhood of the threshold more equitably.

The present bill would cost the Treasury somewhat more in lost revenue because the exemption applies to all institutions rather than just to those below a certain level of total deposits. With an exemption provided solely to depositories with less than $5 million in total deposits, the estimated annual revenue loss to the Treasury would be less than $1 million initially, as shown in Table 4. By contrast, the present bill would involve an estimated loss to the Treasury of about $25 million per year. Any exemption level above $2 million of reservable liabilities would imply still greater revenue loss.

Any higher exemption level immediately raises questions about monetary control as well as revenue loss. Because this exemption applies to all depository institutions, it lowers required reserves at all institutions. In consequence, a higher exemption would increase the number of institutions able to satisfy reserve requirements with vault cash held in the course of everyday business. With exemption levels above $2 million, the percent of transactions deposits at institutions with reserve balances at the Federal Reserve approaches the fraction prevailing before the Monetary Control Act. During deliberations prior to passage of this Act, the Federal Reserve noted that this coverage ratio was already low enough to begin to impair monetary control. The Board finds the proposed legislation acceptable, but with no higher an exemption level than the contemplated $2 million in reservable liabilities. Although the Board does not feel that providing to all institutions an exemption of only $2 million in reservable liabilities would seriously erode control over the aggregates, an exemption above this level would begin to be a cause for concern. We note that the bill would allow the $2 million exemption to be allocated among reservable liabilities in accordance with rules and regulations established by the Board. Under this provision, the Board would allocate the exemption among reservable liabilities in a manner consistent with operational and monetary policy considerations.

The Board would not object to the provision that would index the exemption level to a measure of deposits, although it is not clear to us that it is necessary to achieve the intended results. However, since the exemption applies to reservable liabilities, it would be more appropriate to index the exemption to 80 percent of the growth in reservable liabilities rather than in total deposits. Such treatment would be more comparable to the indexing in the Monetary Control Act of the original $25 million cutoff of transactions deposits between the 3 percent and 12 percent reserve ratios. This cutoff is indexed to a measure of those deposits affected by this provision; that is, to total transactions deposits at all institutions. Draft language for this proposed modification is attached.

In conclusion, the Board fully supports efforts to avoid subjecting smaller depository institutions to undue burdens of reserve requirements. While requirements are necessary for monetary control, we must take care that their costs are not so high as to swamp their intended benefits. Since it would be inappropriate for the Board to continue indefinitely the current deferral of reserve requirements under its own authority, we believe that a resolution of this issue by Congress is necessary to prevent a substantial increase in the reserve burden on smaller depository institutions.

Table 1

Institutions Fully Exempt from Reserve Requirements
Under Alternative Methods[1]

Alternatives		All Depository Institutions[2]: Number of exempt institutions	All Depository Institutions[2]: Percent of all institutions	Number of exempt institutions less than $5 million in total deposits
Current[3]		17,755	44.0	
	Exempt levels of reservable liabilities			
Reserve exemption on first $ X million of reservable liabilities for all institutions[4]	$1 mill.	21,766	53.9	19,321
	2	23,831	59.0	19,745
	3	25,716	63.7	19,858
	4	27,321	67.6	19,879
	5	28,658	71.0	19,882
	Total deposit levels for reserve exemption			
Reserve exemption for institutions with less than $ X million in total deposits[4]	$ 2 mill.	17,992	44.6	
	5	19,882	49.2	
	7.5	21,444	53.1	
	10	22,935	56.8	

1. Edge and Agreement Corporations and U.S. branches and agencies of foreign banks are excluded for the following reasons: (1) no Edge or Agreement Corporations or U.S. branches and agencies of foreign banks are currently exempt; (2) these institutions often have related offices located in different states or different Federal Reserve Districts which all report deposits separately. Each "family" of related offices would allocate a reserve exemption on reservable liabilities among its various offices. Since the impact of such an allocation cannot be known in advance, no estimate is included of the number of reporting offices that would be exempt from reserve requirements under these alternatives; (3) since these institutions are affiliates of much larger organizations, the Federal Reserve believes that a reserve exemption based on their total deposit size would be inappropriate.
2. There are an estimated 40,388 depository institutions at present.
3. Includes all institutions not now subject to reserve requirements. Such institutions either are deferred from reserve and reporting requirements because they had less than $2 million in total deposits on December 31, 1979, or were above $2 million in total deposits on December 31, 1979 and have no reservable liabilities (about 10 percent of the total). An unknown number of the former group likely have no reservable liabilities and thus would be exempt from reserve requirements if the deferral ended.
4. Estimated at current deposit levels.

Table 2

Number of Institutions Fully Exempt from Reserve Requirements
Under Alternative Methods: By Type of Institution[1]

Alternatives		Commercial Banks	Savings and Loans	Mutual Savings Banks	Credit Unions	Total number of exempt institutions[2]
Current[3]		307	415	0	17,033	17,755
	Exempt levels of reservable liabilities					
Reserve exemption on first $ X million of reservable liabilities for all institutions[4]	$1 mill.	507	1,546	13	19,700	21,766
	2	1,526	2,271	46	19,988	23,831
	3	2,782	2,709	99	20,126	25,716
	4	3,960	3,000	147	20,214	27,321
	5	5,018	3,187	183	20,270	28,658
	Total deposit levels for reserve exemption					
Reserve exemption for institutions with less than $ X million in total deposits[4]	$ 2 mill.	354	435	0	17,203	17,992
	5	976	525	0	18,381	19,882
	7.5	1,868	641	2	18,933	21,444
	10	2,868	764	4	19,299	22,935

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Table 3

Percent of Institutions Fully Exempt from Reserve Requirements
Under Alternative Methods: By Type of Institution[1]

Alternatives		Percent of Commercial Banks	Percent of Savings and Loans	Percent of Mutual Savings Banks	Percent of Credit Unions	Percent of all institutions[2]
Current[3]		2.1	9.8	0.0	82.9	44.0
	Exempt levels of reservable liabilities					
Reserve exemption on first $ X million of reservable liabilities for all institutions[4]	$1 mill.	3.5	36.3	3.0	95.9	53.9
	2	10.4	53.4	10.5	97.3	59.0
	3	19.0	63.7	22.6	98.0	63.7
	4	27.0	70.5	33.6	98.4	67.6
	5	34.2	41.8	41.8	98.7	71.0
	Total deposit levels for reserve exemption					
Reserve exemption for institutions with less than $ X million in total deposits[4]	$ 2 mill.	2.4	10.2	0.0	83.7	44.6
	5	6.7	12.3	0.0	89.5	49.2
	7.5	12.7	15.1	0.5	92.1	53.1
	10	19.6	18.0	0.9	93.9	56.8

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Table 4

Reduction in Reserve Balances
at the Federal Reserve and
Estimated Treasury Revenue Loss[1]
(in millions of dollars)

Alternatives		Estimates Based On Current Deposits and Current Reserve Requirements (May 1982)		Estimates Based On Estimated Growth in Deposits and Reserve Requirements After Phase-in (May 1988)	
		Reduction in reserve balances	Net Treasury revenue loss	Reduction in reserve balances	Net Treasury revenue loss
	Exempt levels of reservable liabilities				
Reserve exemption on first $ X million of reservable liabilities for all institutions	$1 mill.	158	13	457	38
	2	290	24	806	66
	3	410	34	1,085	90
	4	528	44	1,323	109
	5	640	53	1,530	126
	Total deposit levels for reserve exemption				
Reserve exemption for institutions with less than $ X million in total deposits	$ 2 mill.	1/4	*	13	1-1/2
	5	5	1/2	32	3
	7.5	15	1-1/4	52	4
	10	34	3	93	6-1/2

* less than .1

1. Estimated net Treasury revenue loss equals the loss of earnings at the Federal Reserve due to the reduction in reserve balances less the estimated taxes paid by the depository institutions affected on the earnings resulting from the reduction in reserve balances.

Appendix to the

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Proposed Amendment to H.R. 6222

Amendment to H.R. 6222

On page 2, line 22, strike out the word "deposits" and insert in its place "reservable liabilities".

On page 2, line 24, strike out the word "deposits" and insert in its place "reservable liabilities".

On page 2, line 25, strike out the word "deposits" and insert in its place "reservable liabilities".

On page 3, line 2, strike out the word "deposits" and insert in its place "reservable liabilities".

On page 3, line 5, strike out the word "deposits" and insert in its place "reservable liabilities".

On page 3, line 6, strike out the word "deposits" and insert in its place "reservable liabilities".

On page 3, line 7, strike out the word "deposits" and insert in its place "reservable liabilities".

On page 3, line 9, strike out the word "deposits" and insert in its place "reservable liabilities".

Purpose: This amendment modifies the basis of indexing the amount of deposits and Eurocurrency liabilities that may be exempted from reserve requirements from the change in total deposits in the banking system from year to year to the change in total reservable liabilities in the banking system from year to year. Reservable liabilities include transaction accounts, nonpersonal time deposits, and Eurocurrency liabilities. This amendment will relate more closely the size of the change in the reserve requirement exemption with the change in liabilities that are subject to reserve requirements.