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Statement by

J. Charles Partee

Member, Board of Governors of the Federal Reserve System

before the

Subcommittee on Financial Institutions, Supervision,
Regulation and Insurance

of the

Committee on Banking, Finance and Urban Affairs

House of Representatives

October 27, 1983

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I appreciate this opportunity to give the views of the Federal Reserve Board on proposals to permit the payment of interest on demand deposits. The Board supports repeal of the existing prohibition on interest payments on demand deposits. We believe that such a step is appropriate at this time in light of the vast changes in banking and financial markets over the last 50 years, and that its benefits in terms of enhanced return to some depositors and a more efficient use of our nation's resources will outweigh the temporarily adverse effects on bank profits.

Congress has already recognized the distortion and inequity inherent in interest rate ceilings on time, savings, and household transaction accounts and, in accord with its Congressional mandate, the DIDC has eliminated ceilings on the great bulk of such deposits. Many of the same arguments apply to the prohibition of interest on demand deposits, and its repeal would complete the process of rate ceiling deregulation. As I will explain later, however, we do have some differences with you, Mr. Chairman, on the details of how to implement the repeal. In addition, we believe it would be desirable to couple a move in this direction with action to begin paying interest on required reserve balances held at Federal Reserve Banks. Finally, as you requested, I will discuss issues associated with brokered deposits.

History and Current Impact of Prohibiting Interest on Demand Deposits.

The prohibition of the payment of interest on demand deposits was first put in place 50 years ago in the midst of the banking crisis that accompanied the deepening economic depression. Banks that were

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members of the Federal Reserve System were banned from paying interest on demand deposits in 1933 and this prohibition was extended to insured nonmember banks in 1935 (and to savings and loan associations in 1982 when they were first authorized to offer demand deposits). The payment of interest on demand balances was thought to have contributed to the great depression in two ways: First, it allowed large city banks to bid funds away from rural areas, primarily through the medium of "bankers balances" or deposits of smaller banks in larger ones. This flow, it was believed, not only drained credit from agriculture and small-town businesses, but also tended to foster speculative excesses in securities markets, since the large banks were alleged to be using the funds to make loans to stock purchasers buying on margin. Second, the unregulated payment of interest on demand and other deposits was felt to have contributed to the weakened condition of the banking system. Excessive competition for funds on a rate basis was thought to encourage banks to generate needed revenue by making riskier loans whose subsequent defaults led to bank failures. In addition, prohibiting interest on demand deposits was intended to reduce costs so that banks could more easily afford the premiums on newly introduced deposit insurance.

With the benefit of historical hindsight, we can now see that some of the reasons given for prohibiting interest payments on demand deposits might not have been as compelling as they seemed at the time. Bankers' balances, or a close substitute for them, would have been held in any case, since they served a number of useful functions to smaller, rural banks, including as a source of liquidity to meet seasonal swings in loans and deposits and to facilitate check clearing and other services

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received from the larger banks. With respect to the effect of interest rate competition, any related deterioration in credit underwriting standards was swamped by general financial and economic events, so that subsequent studies fail to show an association between rates paid on deposits and the incidence of bank failure during the period.

I would note also that the prohibition of interest rates on demand deposits has not prevented the emergence of close, interest-bearing substitutes whose use has greatly eroded whatever effectiveness rate limitations once had. Large account holders--including business corporations and others--long ago began utilizing a variety of instruments and techniques enabling them to minimize the impact of the inability to earn interest on demand deposit balances. And in 1980 Congress authorized the nationwide availability of interest-bearing transactions accounts for households and nonprofit organizations, and in 1982 for governmental bodies.

Certainly, the absence of interest on demand deposits has not inhibited the flow of funds from one area of the country to another. The federal funds market provides an efficient way for banks with surplus funds--often smaller institutions--to make them available at market-determined rates to banks with funding needs--often those located in money centers. Money center banks have come up with a variety of other instruments as well that allow them to bid for large volumes of funds in what is in effect an interregional, indeed, international dollar market.

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In addition, for many banks the prohibition of interest on demand deposits probably has not significantly held down the overall cost of funding. Customers, working with banks, have developed sophisticated cash management techniques that minimize the volume of balances in demand accounts by moving funds on a short-term basis between demand deposits and highly liquid instruments paying market yields. Some instruments, such as money market deposit accounts and money market funds, can even be substituted to a limited extent directly for demand deposits in making transactions; others, including repurchase agreements and Eurodollar deposits, can be acquired for periods as short as overnight to earn interest on surplus balances. Although these techniques were developed initially by and for large corporations, in an environment of high interest rates and improving technology, they have increasingly become available to smaller customers as well.

Moreover, the balances remaining in demand deposit accounts are by no means "free" to the bank. Rather, in exchange for those balances the bank provides a variety of services to demand deposit holders, charging considerably less than their cost. In this way, depositors earn "implicit" interest on their funds in demand deposits. These services include check-clearing, deposit processing, and other transactions associated directly with the use of the demand account itself, and they may involve other banking functions, such as loan commitments, wire transfers, processing credit card drafts and payroll preparation. Banks commonly inform business demand deposit holders what level of balances they must hold so that the bank's earnings from the zero-interest balances cover the expense of providing the services.

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When businesses use cash management techniques to keep their balances to the minimums set by the banks, the implicit interest return to the holder probably about matches the market-determined interest rate that would be paid, and the prohibition of interest on demand deposits offers no cost savings to banks. However, many smaller businesses, and households still holding demand deposits, may not have the expertise or time available to manage their demand accounts that closely. These account holders are earning some implicit interest from the services they receive, but that compensation is likely to be below competitive interest rates, especially for holders of relatively large, inactive accounts.

The Effect of Allowing Interest to be Paid on Demand Deposits

Repeal of the prohibition of interest on demand deposits will affect the banking business in a number of important ways. In general, banks will probably move more rapidly to explicit pricing of the services they offer customers and away from asking for low- or no-interest compensating balances. Interest rates on the various types of deposits available at banks and thrifts are likely to depend primarily on the maturity of the deposit rather than on what the deposit is used for. Just how this process will evolve and precisely what its effects might be can not be predicted with confidence, but some broad outlines can be discerned.

Some bank customers will stand to benefit, most especially those holding higher demand balances than needed to compensate for the services they are now receiving. As I indicated before, the most important class

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of such customers probably is small- to-medium sized businesses. They will be able to realize a return on transaction balances without the expenditure of time and money to learn about and utilize sophisticated cash management techniques. Those already employing such techniques will be free to redirect resources into more productive uses, since interest-earning demand accounts could provide a direct and competitive outlet for holding liquid funds. In addition, more explicit pricing of bank services should help all bank customers achieve a better balance between their use of each type of service and its cost to them.

Of course, not all bank customers will benefit. Households making heavy use of services may find their net compensation reduced by the substitution of taxable explicit returns for tax-free implicit yields on deposit balances, while service charges, which are not tax-deductible, rise. To accommodate these customers, banks may continue to offer accounts paying little or no explicit interest and carrying reduced service charges to depositors whose balances are adequate to compensate for their use of services. However, banks are not going to be able to allow customers whose demand deposits are small relative to the use of services to continue to be subsidized in this fashion, and these depositors will face a higher cost of banking. On balance, however, the movement toward explicit and full pricing of services and deposits should improve and rationalize the provision and use of banking services in this country.

For banks, earnings will be affected by the balance between the cost of paying interest on the deposits and the rise in revenue from the explicit pricing of services. An important factor in this regard is the competitive environment; bank earnings could be reduced

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substantially if a fierce struggle for depositors' dollars develops, with excessive interest rates paid on demand balances or continued underpricing of services being used as "come-ons" to lure depositors from other institutions. But our recent experience with rates on Super-NOW and money market deposit accounts indicates that after an introductory period they have been kept about in line with potential returns to banks and thrifts. Therefore, as a generality, I think it reasonable to expect that interest paid on demand deposits and rates charged for services would reflect fairly quickly the underlying investment opportunities and costs of banks.

Under these circumstances, it is the banks that are now earning more on their investment of interest-free deposits than they are incurring in unrecovered costs to provide subsidized services that would experience some downward pressure on earnings. The intensity of this pressure will depend also on how rapidly deposit funds are shifted into accounts paying explicit interest rates. Eventually the bulk of all transaction funds likely would be held in such deposits. But initially, some holders may not take the trouble to change accounts, and some, as noted above, may prefer the no interest-low service charge combination they now are receiving. The extent of the shifting will depend in part on the structure of the legislation--whether, for example, the DIDC is empowered to put the proposed $2,500 floor on decontrolled balances at first--and on the marketing approach of the institutions.

The negative impact of demand deposit interest on earnings will not be distributed equally across depository institutions. Thrift institutions, for example, have very few demand deposits, and they

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would welcome the opportunity a lifting of the ceiling would give them to compete with banks for business deposits. Large wholesale type banks, who do a sizable share of their business with more sophisticated corporations, also may not feel much of an impact since these corporations probably already are getting a market return on their deposits. Rather the effect will be felt most keenly by small- and medium-sized banks, and large retail branch systems--especially those with a disproportionate share of demand deposits from small- and medium-sized businessses. It is impossible to estimate with any precision just how large this effect would be, and obviously it will vary quite a bit among banks, depending on the particular situation of the institution. But it does seem possible that some classes of banks could be affected considerably, at least until they have had time to make other adjustments in lending rates, service charges and other fee income.

As the entire spectrum of banks' revenues and costs adjusts over time to the new situation, the initial adverse effect on earnings should tend to diminish. Even in the absence of the initiative on demand deposit rates, many of these same adjustments probably would become necessary. Household transaction deposits already have been significantly deregulated and are slated for complete interest rate deregulation by 1986, and it has been evident for some time that careful cash management techniques have been spreading to more and more businesses. Thus, whatever earnings benefit banks are receiving from the prohibition of interest on demand deposits is rapidly eroding in any case.

From a monetary policy perspective, the payment of interest on demand deposits could create more uncertainty with respect to formu-

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lating monetary targets and interpreting incoming information about money growth. The level and behavior of demand deposits relative to income and prices is likely to change as these deposits become more attractive vehicles for holding liquid savings, rather than being used almost exclusively for transactions purposes. Some of the funds that are now normally shifted to close demand deposit substitutes will remain in these accounts given competitive interest rates. At the same time, some of the balances now held in demand deposits solely to compensate banks for services received will be invested elsewhere as explicit charges are placed on these services.

The uncertainties are likely to be greatest in the transition period, when deposit holders are adjusting their behavior to the availability of interest-earning accounts and explicit prices for services. The problem, however, is one of degree, since we are already facing similar difficulties with M1, our measure of transactions money, as a result of the movement of household funds into NOW and Super-NOW accounts. Moreover, by inducing the utilization of demand deposit substitutes and the spread of cash management techniques, the current regulatory framework has created its own problems for monetary policy that the payment of interest on demand deposits would tend to reduce. The Federal Reserve has already had to accept and adjust to the need for increased flexibility when implementing policy in a changing financial environment, and I feel confident that we could deal with the effects of the advent of interest on demand deposits as well.

Implementation of Interest on Demand Deposits

Although the Federal Reserve Board shares the desire to permit interest to be paid on demand deposits, we do have some concerns

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about how this is to be implemented. Generally, we favor the approach in H.R. 3895, which you introduced at the request of the DIDC. It is my understanding, Mr. Chairman, that your own bill differs from the DIDC proposal in three respects.

First, your bill would eliminate the current restrictions limiting thrift-institution checking accounts for businesses to those with other customer relationships. This action, it seems to us, is not appropriate at this time. Thrifts are still in the process of adapting their business strategies to the new powers they obtained only last December. The Federal Reserve believes that the question of a still broader scope for the checking account authority of thrifts should be addressed later on, when the wider issues concerning the structure and organization of the financial system are considered.

Second, we believe that the DIDC should have the authority to decontrol demand deposits in a parallel fashion with NOW accounts. As you know, NOW account interest rates are still regulated for accounts below $2,500--a minimum that will drop to $1,000 in January 1985 before total elimination in the spring of 1986. If the same minimum were not imposed for interest-bearing demand deposits, the DIDC would need to end the regulation of NOW accounts immediately, and probably also savings accounts. In the absence of such action, a sizable volume of funds in savings accounts and smaller NOW accounts would simply shift to deregulated demand deposits. The effect on the earnings of banks and thrifts could be substantial, and I would prefer to see the floor phased out as the DIDC has proposed. At thrift institutions in particular, the need to pay higher rates on $185 billion of savings deposits could have very serious consequences on a still weakened industry.

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Finally, we would urge that the Federal Reserve be allowed to impose full transaction reserve requirements on increases in demand deposits at each institution from the date of enactment, as in the DIDC bill. This provision is necessitated by the nature of the phase-in of reserve requirements for nonmember banks and thrifts under the Monetary Control Act. Congress directed that NOW accounts be subject to full transaction account reserve requirements immediately, while requirements on demand deposits would be brought up to the NOW account level only slowly. Decontrol of demand deposit interest rates would allow thrifts and nonmember banks to avoid full reserve requirements on household accounts for the remaining transitional years by transferring the funds already in NOW accounts to demand deposits. The result would impose an additional, unfair competitive disadvantage on member banks.

Let me reiteriate, Mr. Chairman, that our disagreements are related to technical matters concerning the precise way interest on demand deposits would be phased in—not to the fundamental intent of your bill, on which we are in agreement.

Interest on Reserves

In addition, the Board would urge that any legislation to eliminate the prohibition of interest on demand deposits include a plan to begin paying interest on required reserve balances at the Federal Reserve. The two steps are complementary—interest on reserves will reinforce some of the beneficial effects of allowing interest on demand deposits while alleviating some of the short-run impact on bank earnings.

Reserve requirements serve a vital and efficient role in the conduct of monetary policy; they are the fulcrum through which policy

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actions affecting reserve balances are transmitted to the depository institutions and through them to the general public. But it is not necessary that reserve balances be interest-free. In their present form, reserves act as a tax on the institutions forced to hold them which, like any other tax, probably is partly absorbed by the institutions and partly passed on to the public in the form of lower deposit rates or higher service charges. Such a tax might be justifiable at a time when the government also was setting rate ceilings that held down the cost of deposits, but these ceilings will soon be gone. By enabling depository institutions to compete for savers' dollars on an equal footing with other intermediaries, payment of interest on required reserves could increase the flow of funds through banks and enable depositors to enjoy the maximum benefits of deposit rate deregulation.

We recognize that there are some difficulties associated with the proposal that market interest rates be paid on such reserves. For example, movements in the monetary aggregates--especially the narrow transaction aggregate M1--might become even more difficult to interpret if this substantial regulatory cost, which would tend to force interest rates to be lower on transaction accounts than on other deposits, is eliminated. But by removing one more incentive for people to find new and innovative methods of avoiding holding reservable deposits, interest on reserves, along with interest on demand deposits, may in time contribute to a more stable financial environment and hence to greater ease in making monetary policy.

Interest on reserves would also result in a loss of Treasury revenue. Currently, about $20 billion of reserve balances are held at

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the Federal Reserve, and with the System's portfolio yielding around 10 percent, this generates about $2 billion of revenues annually that are available to be remitted to the Treasury. Of course, a sizable part of any interest paid out to banks and thrifts would be recaptured through increased tax payments by those institutions and their depositors. Nonetheless, at a time when very large federal deficits seem in prospect for the indefinite future, the loss of revenues is a serious matter. To spread the fiscal effects of such a move, therefore, interest payments on reserve balances might be phased-in over a number of years. This could be done by gradually increasing the rate paid on reserve balances until it eventually reached its final level--perhaps keyed to the Federal Reserve's earnings on its portfolio of Treasury bills. Alternatively, full interest could be paid initially only on the reserves held against certain types of deposits, adding to the eligible classes of deposits over time. This would be consistent in its initial stages with the proposals now before Congress to have the Federal Reserve pay interest on reserves held against money market deposit and super NOW accounts. Its disadvantage is the need to allocate reserve balances to deposit classes, and the arbitrary competitive handicap that deposits still subject to the reserve "tax" would incur until the phase-out is complete.

Brokered Deposits

You asked, Mr. Chairman, that I discuss possible regulatory approaches to dealing with problems that may arise in association with bank or thrift use of brokers to obtain deposits. As you know, Chairman Volcker already has responded to your request for suggestions on this subject, and I have attached his letter for reference.

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Briefly, our view is that deposit brokering has a legitimate role to play in our financial system. By channelling funds from areas in which they are in surplus to areas of relative shortage, money brokerage is but one of a number of similar activities that contribute to the efficient functioning of our financial markets. By and large, this works to the benefit of depositor, depository institutions, and the economy more generally.

At the same time, we recognize that deposit brokerage has been subject to abuse, particularly by troubled institutions that have been willing to pay large premiums for brokered funds to bolster their deposit base. Recently, this practice has been facilitated by the technique of placing large sums with a given institution and parcelling them out in pieces of $100,000 or less, so that the holdings of each participating depositor are federally insured. As a result, any market discipline associated with risk is undermined, and the deposit insurance funds are faced with potentially much larger calls on their assets if the troubled institution subsequently fails.

Since there is the possibility of abusing an implied fiduciary relationship between broker and deposit customer, it may be appropriate to require registration and regulations of such firms, perhaps along the lines of the Investment Advisers Act of 1940 already being administered by the S.E.C. The application of suitability standards and disclosure requirements similar to those in this Act to deposit brokers could be quite beneficial.

The most serious aspect of the problem, however, has been the use of brokered deposits by troubled institutions, which we believe can best be approached through closer supervision of the depository

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institutions themselves. The first requirement is to identify institutions that are relying unusually heavily on brokered deposits, or that have increased such reliance sharply over a short period of time. This would alert the primary supervisors of these institutions to the need for in-depth reviews to ascertain whether this practice indicated that the institution was facing fundamental problems, and to take remedial action as warranted.

Beginning with the quarterly call report for September 30, 1983, banks have been required to report the volume of deposits obtained through brokers. This will make possible the monitoring of the amount and distribution of brokered funds and the identification of institutions where brokered deposits account for an unusual proportion of total funding. I would envisage a follow-up review of all such institutions, probing in greater depth the sources, terms and conditions of the brokerage arrangements. It seems to me that such reports, along with on-site inspections where indicated, would enable supervisors to discover and take timely steps against any abusive practices that may be facilitated by the availability of brokered funds.

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BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

PAUL A. VOLCKER
CHAIRMAN

October 3, 1983

Honorable Fernand J. St Germain
Chairman
Committee on Banking, Finance
and Urban Affiars
House of Representatives
Washington, D.C. 20515

Dear Chairman St Germain:

Thank you for your letter of September 6, 1983, requesting the Federal Reserve's views concerning what regulatory and/or statutory action is needed to deal with the activities of "money brokers". You point out that substantial amounts of brokered deposits have been placed in banks that have failed and that in the wake of the failure of the Penn Square bank, money brokers have facilitated the placement of fully-insured deposits, thereby undercutting the market discipline that these investors might otherwise have imposed.

The Federal Reserve shares your concern about the effect of the practices of some money brokers on market discipline and the operation of the financial system. We would point out, however, that in a banking system where individual institutions are subject to geographic limitations — in some cases they are limited to a single office —it is quite natural and, under appropriate circumstances, economically desirable that mechanisms develop to facilitate the transmission of funds from areas of excess savings or liquidity to those areas in need of funds for the legitimate banking and credit needs of consumers and businesses. Brokers have long played and continue to play an important role in this function, and, in so doing, have contributed to a more efficient use of our economy's liquid savings. Brokers have also provided prudent managers of sound banks greater flexibility in the management of bank funding. In considering the activities of money brokers, therefore, the critical issue is to devise a regulatory response that will address the practices considered harmful without substantially impeding the legitimate role of the brokers.

It may be useful in this regard to distinguish between the brokering of funds in very large denominations for sophisticated investors in the nation's largest depositories with the placement of smaller retail type deposits and the more recent practice of splitting brokered funds up into $100,000 fully insured denominations. With respect to the brokering of the larger wholesale deposits, we see no compelling need for regulatory or statutory action since the investors involved

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PAUL A. VOLCKER
CHAIRMAN

October 3, 1983

Honorable Fernand J. St Germain
Chairman
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should be capable of protecting their own interests and there is little evidence to suggest that this activity is causing problems of the type cited in your letter. Since, by definition, the denominations of these wholesale funds are quite large, market incentives pertaining to individual transactions are not eroded, and wholesale brokers tend to deal with the larger banking organizations. These institutions continue to be subject to market scrutiny and discipline due to the fact that they continually raise large volumes of funds in the money and capital markets.

On the other hand, the brokering of fully insured deposits does tend to undercut market discipline and raises safety and soundness issues, particularly when the depository institution pays above market rates for the brokered funds and substantial commissions for the brokerage service. Investors seeking maximum rates of return, often through money brokers, are attracted to the higher rate being offered by these institutions. If the investor or broker limits the deposit to the fully insured $100,000, the investor can obtain both the maximization of return and the minimization of risk. Under such circumstances, brokers of smaller retail type deposits can enable some banks with financial weaknesses to obtain funding that they might otherwise be denied by the discipline of the marketplace.

In light of this discussion, there appear to be two possible approaches to addressing the concerns raised by the activities of money brokers. First, consideration could be given to modifying the deposit insurance system in such a way as to distinguish between brokered and nonbrokered funds and to reintroduce some element of risk to those depositors who place their funds through brokers. Second, banking organizations could be required to make periodic disclosure of the use of brokered funds, distinguishing between amounts obtained through brokered deposits of more or less than $100,000. This would alert the market to heavy users of brokered funds and provide more timely information for possible follow-up to bank supervisors.

We believe that as long as the investor is fully insured, he or she will have little incentive to discriminate among depository institutions on the basis of financial condition and their choice would likely be driven only by rate of return. For this reason, we believe that, absent some regulatory or statutory actions pertaining to insurance coverage, little would be gained by, as some have suggested, requiring that investors be supplied with disclosure material concerning the condition of the financial institutions selected for deposit by the money brokers. We understand that the FDIC and the FSLIC will address issues pertaining to deposit insurance for Federally-insured commercial banks and savings and loan associations. One possibility, for example, would be to reduce or eliminate insurance coverage on brokered retail deposits, thereby reintroducing an element of risk to the depositor. While this may hold some promise for bringing market discipline to bear on the activities of money brokers, we believe that any proposals for modifying the insurance system would have to be carefully considered and structured to avoid the possibility of eroding the strength or undermining the essential coverage of our nation's deposit insurance system.

In our view, a more immediate and fruitful way of addressing this problem is to require greater and more timely disclosure of the use of funds obtained through money brokers. Indeed, the Federal banking agencies have

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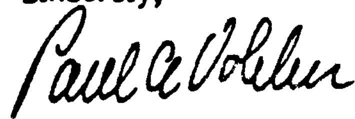
already begun to implement this approach in their revisions to the bank call report. Beginning with the September 30, 1983 call report, commercial banks will be required to report the total amount of funds obtained through money brokers. Further revisions to the call report proposed for March 1984 will obtain both total brokered funds and brokered retail deposits. This information will be reported on a quarterly basis and will be available to the public as well as the supervisory agencies.

We believe this approach has a number of benefits. First, it distinguishes between wholesale and retail brokering and enables supervisory authorities to identify those institutions making heavy use -- or experiencing sharp changes in the use -- of brokered retail funds. Second, the approach avoids restrictions on the legitimate role played by some brokers and avoids the imposition of potentially costly or burdensome regulations. Third, disclosure of brokered deposits may help reinforce market discipline vis-a-vis any remaining large uninsured depositors or nondeposit suppliers of funds. For example, when used in conjunction with disclosure of nonperforming loans, investors, providers of Fed funds, other uninsured creditors and money market participants generally will be better able to identify those institutions whose rapid growth, possibly in combination with asset weaknesses, has forced them to rely heavily on brokered funds. Fourth, this approach is consistent with the general desire expressed by some members of Congress for greater financial disclosure by commercial banks. Finally, and perhaps most importantly, greater disclosure will enable bank supervisory agencies to monitor more effectively those institutions with a large or growing reliance on brokered retail funds and use this information to trigger on-site examinations and, if necessary, formal enforcement action. Information on the volume and growth of brokered deposits, both alone and in relation to total asset growth and other indices of bank soundness, can be factored into our early warning and surveillance systems and into our ongoing procedures for planning and conducting on-site examinations.

Still another approach that has been suggested is a system of registration in connection with which the money brokers would be called upon to meet minimum standards of financial and ethical conduct. We believe that this is a desirable development, and that brokers should be encouraged to develop such standards. However, we do not believe that the present situation requires statutory action. Adoption of the self-policing steps being discussed by brokers and the users of their services would certainly be a step in the right direction.

We hope that this information will be useful to your Committee. Please let me know if I can be of further assistance.

Sincerely,



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