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Statement by

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I appreciate the opportunity to appear on behalf of the Board of Governors to discuss some of the issues raised by the Administration's proposed Financial Institutions Act of 1973. I will concentrate my opening remarks today on those issues which are of direct concern to the Federal Reserve System.

Let me say at the outset that the Board believes there is a need for reform in the structure of financial intermediaries in this country. Such reform should be designed to improve the flexibility of financial institutions to respond to the changing needs of individuals and business, while maintaining a base for effective monetary policy and preserving the soundness of the overall financial system. The changes needed can be accomplished to a large extent by eliminating or moderating present restrictions on the various types of financial institutions, and by providing for greater competitive equity among them. S. 2591 moves substantially in this direction.

The effect of S. 2591 on the Federal Reserve System and its member banks can be separated into four major areas-- loan and investment powers, interest ceilings, deposit and check powers, and reserve requirements. I will discuss each of these areas in turn, referring to the current law and the main reasons

therefor, the key arguments for changing the law at this time, and the Board's views regarding the proposed changes. While my statements on the current law will be brief, I can, if the Committee wishes, file a memorandum outlining the legislative history of the relevant statutes in greater detail.

#### LOAN AND INVESTMENT POWERS

The Board supports the proposed changes relating to the investment powers of commercial banks, and has recommended enactment of similar measures in the past.

It is proposed to remove the restrictions on the authority of national banks to make loans secured by real estate, which authority is presently limited both qualitatively and quantitatively. At one time, national banks were prohibited from making mortgage loans because it was considered unwise to permit banks accepting deposits on a demand basis, as was then usually the case, to make loans with long maturities. The prohibition has been progressively relaxed over the years as banks have generally demonstrated the ability to obtain funds on longer terms and to manage their liabilities, and as secondary markets have developed for mortgage loans. The remaining statutory restrictions are no longer needed to assure sound lending practices, and their removal would have the positive effect of increasing to some extent mortgage lending activities of national banks.

It is also proposed to liberalize the collateral requirements imposed on banks when they borrow from the Federal Reserve at the discount rate. Of course, all loans from Federal Reserve Banks to member banks must be fully collateralized. Originally, all such loans had to be secured by a narrowly defined class of presumably liquid assets, a limitation based on the now-abandoned "real bills" doctrine. Later, advances were permitted on the security of other assets such as mortgage loans and municipal securities, but only at a penalty rate of an additional one half of one per cent above the discount rate. The proposed elimination of the penalty rate would eliminate an indirect restriction on the portfolios of member banks, and would also simplify operations of the Federal Reserve Banks.

An additional proposal is that national banks be permitted to make equity investments in community rehabilitation projects. National banks have been generally prohibited from making equity investments or purchasing equity securities, in order to protect both depositors and borrowers from bank efforts to speculate in equity positions. The Board believes it is wise to continue this general prohibition on all depository institutions, but with the modifications proposed to allow for limited equity investments in corporations established for the purpose of community development.

## INTEREST ON DEPOSIT ACCOUNTS

The second major area in which changes are proposed concerns interest paid on deposit accounts.

The Federal Reserve, Federal Deposit Insurance Corporation, and Federal Home Loan Bank Board are currently provided with parallel authority to set interest rate ceilings on time and savings deposits, after consultation with one another, with discretion provided to set different ceiling rates for different types of accounts. Payment of interest on demand deposits is prohibited.

The restrictions on interest payments by banks came about as a result of the crises of 1929 and 1933. The intended purposes were to prevent the shifting of funds from country banks to big money center banks to finance stock market speculation, and to prevent banks from engaging in unsound banking practices by competing for deposits through payment of excessive interest rates and then trying to meet the increased cost of deposits by acquiring high-yielding but risky assets. Subsequently, scholars studying this period have questioned these two original rationales, and in practice interest ceilings have come to be used more for other purposes.

In recent years, emphasis has been given to utilizing rate ceilings to hold down flows of funds among depository institutions. A combination of factors has led to this result. Beginning in the mid-1950's, after two decades of ample liquidity, commercial banks began to feel the pinch of increasing demands for credit and greater competition for funds from thrift institutions and market securities. Banks responded to this situation by raising their interest rates paid on time deposits, thus creating pressures which eventually resulted in higher interest ceilings. Banks also increased the variety of their deposit accounts by offering various certificates of deposit at attractive interest rates.

Meanwhile, savings and loan associations were experiencing somewhat different but related difficulties. These institutions, as we all know, are almost totally dependent on consumer time and savings deposits for funds, and invest the bulk of these funds in fixed-rate long-term residential mortgages. As a result of this practice of borrowing short and lending long, many thrift institutions found themselves in a dilemma during the periods of high interest rates which emerged. Increasing their savings rates to attract deposits would have resulted in operating losses. On the other hand, paying lower interest rates than competing institutions and market instruments could have led to an outflow of deposits.

Partly in an endeavor to ameliorate these interest rate problems, deposit rates of most savings and loan associations were brought under Federal regulation in 1966. Since that time, the current network of deposit interest ceilings has helped to control rate competition among institutions on balance, but it has also contributed to the diversion of funds from financial intermediaries to market instruments during periods of tight money. The move of thrift institutions to offer longer-term certificates of deposit has been a very helpful, but still insufficient, development in response to the continuing problem of fluctuations in savings flows and housing finance.

Section 103 of S. 2591 provides for a gradual phase-out of interest rate ceilings, with complete removal 5-1/2 years after enactment of the legislation, and a gradual phase-out of the interest differential between commercial banks and thrift institutions. To enable the thrift institutions to compete effectively for funds during periods of high interest rates without the protection afforded by rate ceilings, these institutions would be given expanded powers to diversify into more liquid types of loans.

I must report to you the Board's concern that the proposed new investment powers might well not be sufficient to assure that

thrift institutions could compete effectively for deposits during periods of high interest rates. The Board is also concerned that the proposed asset diversification could have an adverse impact on housing finance that would not be offset by other provisions in S. 2591. These possibilities seem to us to suggest that regulatory agencies be allowed some leeway in speeding or slowing the proposed changes.

Accordingly, the Board would favor a gradual lifting of interest ceilings, contingent on a demonstration that thrift institutions and small commercial banks can perform their functions properly with relaxed interest rate controls during periods of high interest rates. Even after ceilings are removed, the Board would regard it as prudent to have standby authority to reimpose ceilings should it become clear that uncontrolled rates threaten to undermine the safety and soundness of depository institutions or to conflict with other public interest considerations.

Regarding the authority to set interest ceilings, the Board supports the Administration proposal to add the Treasury to the group of agencies required to consult together in setting such ceilings, but otherwise to leave such authority unchanged.

With respect to the provisions for truth in savings, the Board supports the concept of full disclosure of the terms and conditions applicable to savings deposits, on a uniform basis for all depository institutions. The Board would like to report that its study on certain aspects of this matter, requested by four members of this Committee, is proceeding. When it is completed, the Board will also submit a technical analysis of the disclosure requirements set forth in section 106.

#### DEPOSIT AND CHECK POWERS

Let me turn now to the third major issue, deposit and check powers.

It is proposed that national banks be allowed to offer savings accounts to corporations. Since the Banking Act of 1933, savings deposits have been the only class of deposits payable on demand with respect to which member banks are permitted to pay interest and to maintain reserves at levels lower than those for demand deposits. On the basis of its conclusion that the purpose of so favoring savings deposits was to encourage personal thrift, the Board ruled in 1936 that such deposits should not be made available to profit-making corporations. To reverse that policy and allow corporate savings deposits we believe would expose

financial institutions to potentially destabilizing shifts of business funds, and could invite the transfer of working balances of corporations into savings deposits in order to avoid the higher reserve requirements on demand deposits and the interest prohibition thereon.

It is also proposed that all banks and thrift institutions be allowed to offer negotiable order of withdrawal accounts, so called "NOW accounts," to all customers, with interest ceilings to be authorized for 5-1/2 years at a level not to exceed the ceiling on commercial bank savings deposits. NOW accounts, of course, are in many ways interest-bearing checking accounts except that, legally, prior notice may be required before withdrawal.

Public policy regarding NOW accounts is in the formative stage. Experimentation with this form of service is presently underway in Massachusetts and New Hampshire. The Board believes that such experimentation will work best if it proceeds in a constructive and orderly manner. Consistent with this belief, the Board has published for comment proposed restrictions, at least initially, on NOW accounts of member banks in the two States that are designed to constrain possible deposit shifts into NOW accounts and to moderate the immediate earnings impact, particularly on smaller consumer-oriented commercial banks which may require time to adjust operating policies and service charges to this new environment.

In previous testimony before this Committee, the Board has recommended that all depository institutions be allowed to offer NOW accounts, so long as all such institutions are subject to the same interest ceilings and the same schedule of reserve requirements on these accounts. The Board also believes that NOW accounts should be restricted to families and specified types of non-profit institutions. Corporations generally find it possible to keep surplus funds continuously invested in market instruments and often earn interest implicitly on demand deposits through receipt of free bank services. Individuals, on the other hand, are more dependent on the range of services offered by financial institutions and have the most to gain through NOW accounts. The Board believes that NOW accounts should have lower reserve requirements than demand deposits, but only if such accounts are limited primarily to families.

Allowing thrift institutions to offer NOW accounts raises a question with respect to the clearing of checks. Since thrift institutions have generally been limited in the offering of checking accounts, existing legislation does not deal specifically with check collection for thrift institutions or the Federal Home Loan Banks. The existing practice is for thrift institutions to clear checks through commercial banks with whom they keep balances. The

Board believes that thrift institutions should have access to Federal Reserve check processing services on an equitable basis with member banks, provided that they meet Federal Reserve reserve requirements.

#### RESERVE REQUIREMENTS

The fourth major area in which the proposals would directly affect the Federal Reserve is reserve requirements. The Board is authorized to set reserve requirements on deposits of Federal Reserve member banks within statutory limits.

The Board strongly believes that a uniform schedule of reserve requirements should apply to demand and NOW-type accounts of all depository institutions. That authority will be sought in a separate bill to be submitted by the Board later. The provisions of S. 2591 extending Federal Reserve reserve requirements to the demand and NOW deposits of FHLB members are a step in the right direction.

Membership in the Federal Reserve System has always been optional for State banks. Formerly, nonmembers were collectively small in comparison to member banks, and the major banks in larger cities were members. This situation is changing, however, in a manner which has serious long-run implications for

monetary policy. The proportion of commercial bank deposits held by nonmembers has already climbed to 22 per cent and seems to be increasing at an accelerated rate.

The various State reserve requirements applicable to nonmember banks are designed to assure at least a minimum degree of individual bank liquidity and soundness. Federal Reserve reserve requirements, however, serve an additional and very important purpose: namely, they provide the fulcrum against which monetary policy operates.

At present, reserve requirements for Federal Reserve members are substantially more onerous than those for nonmembers, mainly because of the form in which reserves are held. Although the requirements vary from State to State, nonmembers are generally permitted to include as reserves balances held at other banks, for which services are often received in return. More than half the States count as reserves uncollected balances at other banks, and nearly half the States allow interest-bearing securities to be counted toward part or all of their reserve requirements. For member banks, in contrast, vault cash and collected balances at Federal Reserve Banks are the only permissible ways of meeting our reserve requirements.

Such wide differences in reserve requirements create an incentive for member banks to withdraw from the System and for newly chartered banks to choose not to seek System membership. Should the percentage of bank deposits subject to Federal Reserve reserve requirements continue to decline, progressively greater imprecision, uncertainty, and delay would be injected into the Federal Reserve's ability to implement monetary policy.

The Board will not propose that System membership be required for all institutions offering checking accounts, as was recommended by the Hunt Commission. However, for purposes of both effective monetary policy and a more nearly equitable sharing of the burden of monetary policy, the Board considers it essential that all demand and NOW accounts be subject to uniform reserve requirements, with all reserves represented by vault cash or deposits at the Federal Reserve Banks.

S. 2591 proposes that the Board be given authority to determine the form in which reserves may be held. It is the Board's present intention, if such authority is provided, to continue the current policy of allowing only deposits at Federal Reserve Banks and vault cash to be counted toward the reserve requirement. In the case of thrift institutions, the Board does not object to having

reserves held in the form of deposits at Federal Home Loan Banks, so long as such reserves are redeposited with the Federal Reserve Banks and thus not used to carry out policies that may at times be inconsistent with Federal Reserve monetary policy.

In view of the Board's responsibility for monetary policy, the Board is concerned with the proposal that it consult with the FHLBB in setting reserve requirements. In particular, the Board strongly opposes consulting with the FHLBB in changing demand deposit reserve requirements. Furthermore, the Board does not believe that thrift institutions should be empowered to offer demand deposits.

The Board also does not object to the new statutory limits proposed for reserve requirements, although it sees no pressing reason to change the existing limits. At some future date, higher reserve ranges might be needed on certain time deposits such as large certificates of deposit, depending upon how the preferences for and uses of the various types of accounts evolve over time.

#### OTHER KEY ISSUES

Several other key issues are raised by S. 2591, some of which are so important that this testimony would not be complete without a discussion of them.

The Board wishes to stress the need for gradual transition in the implementation of the proposed reforms. Even with careful planning and detailed study, it is impossible to determine in advance the results of the interaction of the various regulatory changes that are proposed. It is possible that unplanned transitional developments could result in strain to some financial institutions or to some sectors of the economy. The Board believes, however, that the goal of a more flexible financial system is sufficiently important to undergo the transition.

The bill calls for gradual implementation of several changes through steps. Thrift institutions would be allowed to increase their investment in corporate debt securities by two per cent per year until the allowable percentage is ten per cent. The Board endorses such transition measures, and recommends the gradual phasing-in of all new investment powers for thrift institutions.

Another transition measure of great importance is discretion for regulatory agencies to react to unforeseen developments. I cited earlier the need for close coordination of the gradual removal of interest ceilings with the proposed asset diversification for thrift institutions. Other areas that call for such discretion in timing include the introduction of NOW accounts and the removal of the differential in interest ceilings between banks and thrift institutions.

CONCLUSION

In summary, the Board hopes that Congress will enact legislation to implement the basic thrust of S. 2591. In a few areas that I have mentioned, we would suggest some modifications.

We look forward to helping the Committee in any way that we can as the deliberations move ahead.