

**For release on delivery**  
**Expected 10:00 A.M. E.D.T.**

**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**

**U. S. House of Representatives**

**May 15, 1979**

I am pleased to appear today on behalf of the Federal Reserve Board to discuss H.R. 3864, the Consumer Checking Account Equity Act of 1979. I understand that the bill was introduced in response to the recent ruling by the U.S. Court of Appeals for the District of Columbia that automatic transfers from savings accounts, credit union share drafts, and savings and loan association remote service units will not be authorized by law after January 1, 1980. While the legal demise of these accounts is not yet certain, since the affected regulatory agencies are planning to appeal the decision, the Board believes that now is an opportune time for the Congress to reconsider the issue to see whether agreement can be reached on a more rational system permitting consumers to obtain interest on their transactions balances.

The Federal Reserve Board for some time has supported the principle of interest payments on transactions balances at all depository institutions. Our support of this principle is based on considerations both of economic equity and efficiency. Corporate depositors as well as some informed smaller depositors already earn something approaching market rates of return on their transactions balances through the implicit receipt of interest in the form of banking services provided at little or no charge. Alternatively, sophisticated depositors are able to minimize their holdings of non-interest bearing deposits by placing their funds in overnight investments that can readily be mobilized for transactions purposes. It is only fair that smaller, less sophisticated depositors have similar opportunities. In addition, since

the prohibition against explicit interest payments on transactions balances has led banks to compete on the basis of checking and other services at low or no cost, deposit customers are encouraged to make a greater use of such services than would be the case if they were explicitly priced.

The payment of interest on transactions accounts would encourage financial institutions to compete for deposits directly and to charge for their services on the basis of costs incurred. Most members of the public would likely be better off in an environment in which all depository institutions offered explicit interest on transactions balances--consumers would have a more rational basis for choosing among financial services; they would probably receive higher effective interest returns on their funds due both to increased competition for transactions balances among financial institutions and to increased efficiency in the financial sector; and deposit customers would have less need to spend time and money attempting to minimize their holdings of non-earning transactions balances.

The Board, however, would urge a more gradual and, we believe, less disruptive approach than that contained in H.R. 3864. Given our lack of knowledge about the transitional problems, it seems important that the removal of the prohibition should be accomplished gradually, by extending an activity with which experience has already been gained. I am referring to nationwide NOW accounts which could be implemented by legislation similar to the NOW proposal passed by the Senate Banking Committee in 1977 as part of S. 2055. Specifically, the Board favors nationwide NOW accounts, authorized for all depository institutions, but

limited initially to individuals and nonprofit institutions. Such accounts should be subject to deposit rate ceilings, equal among the institutions, during a transitional period. And the Board strongly believes that all nationwide NOW accounts must be subject to reserve requirements, both because of the importance of the reserve requirement mechanism for the efficient conduct of monetary policy and in the interests of institutional equity.

A major virtue of this alternative approach is that it would moderate the transitional impact on commercial bank and thrift institution earnings that is likely to result from competition for market shares when a new interest-bearing transaction account is first introduced. That the transitional effect on earnings can be significant is evidenced by our experience with NOW accounts. In the early years of NOW's in New England the combination of ceiling interest rates on deposit balances and no or low service charges for NOW drafts was much more costly to depository institutions than could be justified in the long run. Over time, the New England institutions increasingly came to link explicit interest on transaction accounts with explicit charges for checking and other services rendered. Minimum balance requirements were developed, and service charges began to approximate true costs. Experience gained in the two original NOW states was used to advantage in those states that later received NOW account authority. Thus, we would expect that institutions in the other 43 states, when given NOW authority, would also be able to build upon this experience in designing their service packages. As a

result, an effective implementation date of January 1, 1980, probably would provide institutions with a sufficient planning horizon, if the enabling legislation proceeds promptly.

Nevertheless, Board staff analysis suggests that, without a deposit rate ceiling coordinated by the agencies, the actual cost of NOW account funds to the institutions might rise temporarily by several percentage points above the long run sustainable rate in those states gaining NOW powers for the first time. Our staff estimates that, in the absence of such regulation, pre-tax earnings of all commercial banks during the worst year of the transition period could be expected to be between 5 and 7 per cent lower than otherwise. While such earnings reductions would not pose problems for the vast majority of commercial banks, they would be troublesome for individual institutions that have unusual concentrations of consumer accounts or that may already be experiencing an earnings squeeze. Thrifts could be expected to compete vigorously with the banks for interest-bearing transactions accounts and such competition could be quite costly to them, since for most this would constitute a new service line. The earnings of thrifts already are being squeezed by the currently high cost of their liabilities, especially money market certificates, and by the limited flexibility of the yields they can earn on their long-term portfolios of fixed-rate mortgages.

Thus, the Board is quite concerned about the transitional impact of interest on transactions accounts and we believe there are several reasons why our proposal would have a much smaller

short-run impact on the earnings of financial intermediaries than would the program contained in H.R. 3864. First, the approach we suggest would contain specific and clear authority for the coordinated imposition of a ceiling rate on transaction balances, to be followed by an orderly phasing out of that ceiling over a period of time. Second, nationwide NOW accounts for individuals and nonprofit organizations would be a logical extension of existing programs in New England and New York. Depository institutions in other states could use the experience of existing NOW institutions to avoid pitfalls in designing and implementing their own NOW packages. Third, limiting interest payments to individuals and nonprofit organizations would reduce the exposure of financial institutions to earnings drains while still providing interest relief to those groups least able to obtain direct returns on their transaction balances by other means. Finally, the basic characteristics of a NOW account are consistent with the powers of all depository institutions, since they can be regarded as a form of savings account. They thus may be less costly to develop for thrifts, which are familiar with the structure and administration of savings accounts. Also, State authorities may find that permitting thrift depositors to write drafts against savings deposits would be less difficult to implement than obtaining demand deposit powers for State-chartered thrift institutions.

Once the short-run impact of interest on transactions accounts has been absorbed by the financial system, the categories of depositors eligible for NOW's could be broadened and the ceiling

rate phased out. However, the longer-run effects of major institutional changes are always uncertain and the Board believes that such liberalization should be considered only after experience is gained with a more cautious program--a program that has substantial benefits for consumers, encourages efficiency and competition in the financial sector, maintains the safety and soundness of the financial system, allows for revision over time, and protects the Federal Reserve's ability to regulate the money supply.

With the Board's general preference for NOW's as background, I would like to discuss briefly some specific concerns the Board has with H.R. 3864.

First, the legislation proposes that the level of reserve ratios for transactions accounts at covered savings and loan associations be set by the Federal Home Loan Bank Board and that reserve ratios for covered credit unions be set by the National Credit Union Board. Although these agencies would be required to consult with the Federal Reserve Board in setting reserve requirements, it is clear that the decision would rest solely with those agencies. However, the setting of reserve ratios on transactions balances--that is, the setting of reserve ratios on money--is an integral tool of monetary policy. Such power ought properly to be the province of the nation's central bank.

Second, the proposed legislation would require savings and loan members of the Federal Home Loan Bank System to hold reserves in the form of currency and coin, or in deposits at their respective Home Loan Bank; the form and place of reserves held by Federally-chartered credit unions would be specified by the National Credit

Union Board. Again, to exercise control over transactions balances, the central bank must have control over the total amount of reserves supporting these balances. The reserve accounting could conceivably be handled by--and the necessary reserve deposits passed through from--the primary regulatory agencies. But unless required reserves are held only in vault cash or in balances at Federal Reserve Banks, the Federal Reserve's ability to control reserve availability is compromised.

Apart from the monetary policy implications of the treatment of reserve requirements under H.R. 3864, the bill could lead to a worsening of the competitive imbalances that already exist among our various financial institutions and could lead to operational difficulties as well. For example, if the agencies were to set reserve ratios for S&L's and credit unions lower than those imposed on transactions accounts at member commercial banks, member banks would be placed at a disadvantage to thrifts--as they are now to non-member banks--in competing for checking-type funds. Also, unless thrifts' reserve balances are credited to their accounts at the Federal Reserve Banks, such funds could not be used as clearing balances for purposes of settling checks passed through the Federal Reserve payments system. The clearing mechanism is a vital part of our monetary system, and should be accessible to all kinds of transactions accounts on equal terms and conditions.

In addition, the reserve requirement provisions contained in H.R. 3864 seem inequitable and deficient with respect to the classes of depository institutions that would be subject to required reserves

and the types of deposit account that would be subject to reserves. According to our reading of the bill, four classes of institutions--insured non-member commercial banks, insured mutual savings banks, State-chartered credit unions, and State-chartered savings and loan associations that are not members of the Federal Home Loan Bank System--would not be subject to any reserve requirements under the bill. Further, it would appear that financial institutions (except for Federal Reserve members) would be required only to maintain reserves against demand deposits, but not against NOW's. Obviously, if reserves are not required to be maintained against NOW accounts, thrifts would avoid offering interest-bearing demand deposit accounts, but instead would gain a competitive advantage over member banks by offering reserve-free NOW's.

The ambiguities and exclusions in the treatment of reserves under H.R. 3864 not only would complicate the conduct of monetary policy and lead to competitive inequities, but also might encourage unnecessary and disruptive switching of charters by savings and loan associations and credit unions in order to avoid reserve requirements. Indeed, as you know, the non-universality of reserve requirements for banks has created substantial competitive problems within the commercial banking industry; H.R. 3864 would likely extend these difficulties to thrift institutions.

I would like to turn now to a final point that I hope will demonstrate the complexity of this area as well as underscore the Board's strong belief that interest on transactions balances should be coupled with a solution to the membership problem. As I noted earlier, the payment of interest transactions accounts would exert downward pressure on bank earnings. This would make member banks even more aware of the costs of membership and, in all

likelihood, serve to accelerate the rate of membership attrition. Here, again, our experience with NOW accounts in New England is instructive--the introduction of NOW accounts there placed particular pressure on bank earnings, and membership withdrawals in that region increased sharply.

But even if all institutions were required to hold equal reserves with the System against interest-bearing transactions balances, the membership problem might still be exacerbated. The question would arise as to whether, and to what extent, non-members holding reserves with the System should be allowed access to Federal Reserve services such as check clearing, wire transfer, and use of the discount window. If non-members were given access to System services, they would be subject to a substantially lower reserve requirement burden than members--because non-transactions accounts would not be reserved--but would have access to valuable rights and privileges of membership. As a result, withdrawals of member banks to "non-member service" status would be vastly encouraged.

Thus, while the Board continues to endorse the general principle of interest on transactions balances, we could not support such a program unless steps are taken to halt member bank attrition and reverse the declining proportion of deposits subject to reserve requirements administered by the Federal Reserve. The provisions of H.R. 3864, or even our preferred alternative of extending NOW's nationwide, would accelerate withdrawals by Federal Reserve members and would, therefore, undermine the ability

of the central bank to conduct monetary policy effectively and to continue to backstop the liquidity of our banking system. The concerns of the Board now are even more pressing than in June of 1977 when former Chairman Burns stated before the Senate Banking Committee: "We could not support nationwide extension of NOW account authority if that extension were not coupled with action to lighten the burden of Federal Reserve membership. The risk to the safety and soundness of our banking system of enacting the first part of the package without the second would, in the Board's judgment, be intolerably large."

# # # # # # # # # # # #