an economic review by the Federal Reserve Bank of Chicago

# Business Conditions

International banking—structural aspects of regulation

Banking developments

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# International banking—structural aspects of regulation

By the end of 1973, approximately 140 U.S. banks had established themselves in 150 foreign countries by means of branches or subsidiaries. Until recently, a U.S. bank established an arm overseas primarily to extend traditional domestic bank services to overseas customers, in particular, the subsidiaries of U.S. multinational corporations. In more recent years, however, U.S. banking organizations have diversified the scope of services available to their overseas customers and with these services have tried to attract new customers from the countries in which they are doing business.

On the other side of the coin, foreign banks have penetrated the U.S. market to the extent that 168 foreign banks from 38 countries had established some form of organization in the United States by the end of last year. Total assets in the United States of foreign banking organizations exceeded $50 billion as of mid-1974. Only about 60 of the foreign banking organizations operating in the United States are directly engaged in a commercial banking business, while the range of activities of foreign banks in the United States also includes investment banking, venture capital financing, and real estate development.

These indications of ongoing changes in the scope and nature of the U.S. banking presence in foreign countries and the introduction of a substantial foreign banking presence to the United States led the Board of Governors of the Federal Reserve System to create the Steering Committee on International Banking Regulation in February 1973. Composed of four members of the Board of Governors and three Federal Reserve bank presidents, the Steering Committee is charged with the responsibility of reassessing the structural aspects of U.S. international banking regulations that involve home-country responsibilities for U.S. banks overseas and host-country responsibilities for foreign banks operating in the United States.

## Home-country regulation of U.S. banking organizations overseas

The Board of Governors of the Federal Reserve System is the prime U.S. agency involved in regulating the international operations of U.S. banking organizations.[1] The Board's statutory authority for this regulatory responsibility stems from:

- Section 25 of the Federal Reserve Act as amended in 1916, 1962, and 1966;
- Section 25(a) of the Federal Reserve Act (added in 1919 and also known as the Edge Act);
- The Bank Holding Company Act of 1956 as amended in 1970.

The Board implements its statutory

[1]For purposes of this article, a U.S. banking organization includes the bank itself; the bank holding company, if pertinent; those subsidiaries of the bank holding company that are collateral affiliates of the bank; direct subsidiaries of the bank, for example, an Edge corporation; and indirect subsidiaries of the bank, namely the equity interests of the direct bank subsidiaries. Again for this article, a foreign banking organization is defined as an organization, non-United States in origin, which in its home market and in foreign markets conducts activities that are engaged in by what are commonly considered to be banks in those markets.

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authority with Federal Reserve regulations that apply to U.S. banking organizations that engage in overseas operations via:

- Branches (statutory authority over member banks from Section 25 of the Federal Reserve Act, implemented by the Board's Regulation M);
- Direct equity participations in foreign banks (statutory authority over member banks from Section 25 of the Federal Reserve Act, implemented by Regulation M);
- Equity participations in foreign banking and nonbanking firms by U.S. bank holding companies (statutory authority from the Bank Holding Company Act of 1956 as amended in 1970, implemented by Regulation Y);
- Branches and agencies of Edge corporation or agreement corporation subsidiaries of a bank, and equity participations by such subsidiaries in foreign banking or nonbanking firms (statutory authority from Sections 25 and 25(a) of the Federal Reserve Act, implemented by Regulation K).[2]

Other regulatory agencies exercise jurisdiction over the foreign activities of U.S. banking organizations in specific areas. The Comptroller of the Currency is responsible for the examination of the overseas branches of national banks. State banking authorities retain complete jurisdiction over the foreign branching activity of state-chartered nonmember banks and share jurisdiction with the Board of Governors for the activities of overseas branches of state-chartered member banks. However, the Board—not state banking authorities—has full jurisdiction over state banks, membership notwithstanding, as regards investments in Edge corporation foreign subsidiaries and the foreign activities of domestic bank holding companies that hold state banks.

## Regulatory philosophy

From a legal viewpoint, a branch of a U.S. bank is an integral part of the bank itself, while any other part of the banking organization (i.e., any segment separately incorporated) is legally separable from the bank.[3] The significance of this legal structuring is that the creditors of the bank are legally separable from the creditors of any other part of the banking organization. This legal compartmentalization of creditors' claims has been utilized by the Board as the basis for the regulation of the organizational forms that U.S. banking organizations assume for their overseas activities.

Ever since passage of the Edge Act in 1919, the Board has had the authority to allow a separately incorporated Edge corporation to exercise those powers which, in the Board's view, could be considered usual ". . . in connection with the transaction of the business of banking or other financial operations in the countries, colonies, dependencies, or possessions in which it

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[2]Edge Act corporations and agreement corporations differ in several ways. Edge Act corporations operate under federal charters granted by the Federal Reserve Board; agreement corporations operate under state charters, although they are subject to Federal Reserve regulation.

There are some state corporations with charters identical to those of agreement corporations that are not agreement corporations. These corporations have not entered into a regulatory agreement with the Federal Reserve Board because no member bank has an ownership interest in them, and the Board's jurisdiction is limited to specifying what is an acceptable investment for a member bank.

Receipt of an Edge corporation federal charter does not require the equity participation of a bank. Section 25(a) of the Federal Reserve Act does specify that a member bank's equity participation in an Edge corporation shall be limited to 10 percent of its capital and surplus.

Both Edge Act and agreement corporations can engage in international and foreign banking, either directly or via equity participations, but only Edge corporations can engage in finance operations.

[3]See paragraph 5600 of the *Published Interpretations of the Board of Governors of the Federal Reserve System* for the Board's interpretation of the relationship of the branch to the bank.

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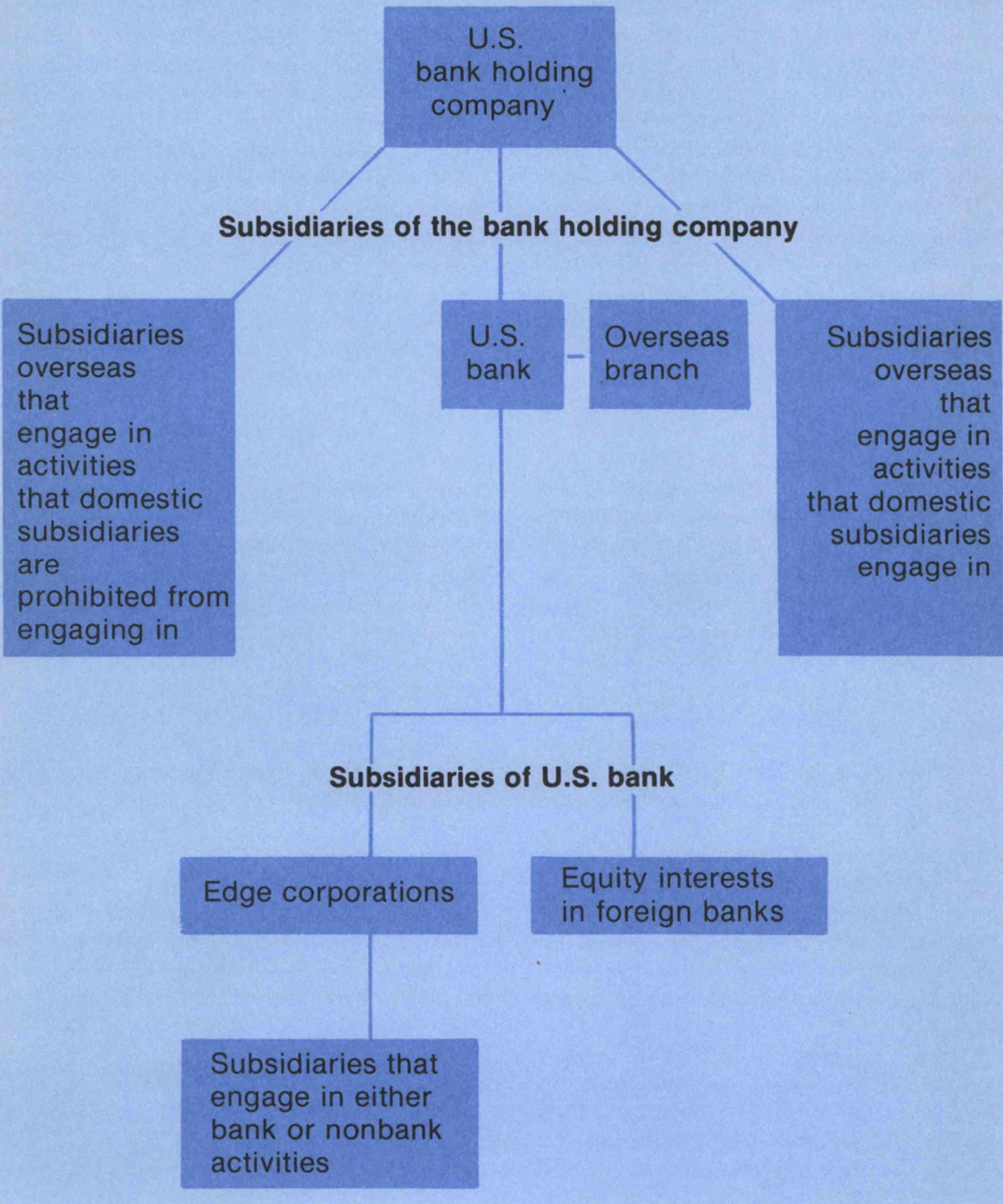


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shall transact business." But prior to 1962, the Board had no authority to alter banking powers to make foreign branches of U. S. banks more suitable to operate in the countries in which they were located. In 1962, Section 25 of the Federal Reserve Act was amended to give the Board statutory authority to allow a foreign branch of a member bank to ". . . exercise such further powers as may be usual in connection with the transaction of the business of banking in the places where such foreign branch shall transact business. Such regulations shall not authorize a foreign branch to engage in the general business of producing, distributing, buying or selling goods, wares, or merchandise; nor . . . shall such regulations authorize a foreign branch to engage or participate, directly or indirectly, in the business of underwriting, selling, or distributing securities."

A further amendment to Section 25 in 1966 gave the Board power to authorize direct equity participation by U. S. member banks in foreign banking corporations. The amendment's only limitation on the power exercisable by such a foreign organization is that the foreign bank cannot be engaged in any activity in the United States except that which is "incidental to the international or foreign business of such foreign bank." The 1970 amendments to the 1956 Bank Holding Company Act—in Section 4(c)13—provided the Board with the discretion to allow domestic bank holding companies to acquire foreign nonbank corporations engaging in activities which would not be permissible domestically, if the foreign company did no business in the United States except as incidental to its international or foreign business.

When, in 1963, the Board revised Regulation M, the revision was designed to provide a limited degree of additional flexibility for overseas branch operations—for example, it allowed branches to create acceptances against trade taking place wholly within a foreign country and to guarantee payments of customs duties. Since 1963, the Board has not altered the pertinent sections of Regulation M and, to insure the solvency of banks, has embedded within the regulatory structure the tenet that overseas branches are extensions of the domestic operations. In contrast to this conservative attitude toward the overseas activities of branches, the Board has been willing to reevaluate the restrictions it places on the overseas activities of U. S. banking organizations that assume anything other than the branch form. A particular example of the Board's flexibility in this area is seen in its allowing U. S. banking organizations to set up investment banking subsidiaries to participate in the Eurobond market, a market which prior to the elimination of U. S. capital controls in January 1974 was substantially devoted to the satisfaction of the overseas capital requirement of U. S. multinational corporations.

What has taken place over the past decade, therefore, is that the Board has been given the statutory authority to effect considerable liberalization of the powers exercisable by U. S. banking organizations in overseas markets. However, the Board has been cautious in its augmentation of the range of overseas activities allowable to U. S. banking organizations, particularly overseas branches.

## Other criteria

In determining which activities will be allowable for U. S. banking organizations overseas, with the exception of branches of member banks, the Board considers three factors:[4]

[4]The Board's discretion in such matters is circumscribed by statute. An example of statutory limits is found in that part of Section 25(a) of the Federal Reserve Act that prohibits equity participation by an Edge Act corporation in a firm engaging "in the general business of buying or selling goods, wares, merchandise or commodities in the U.S."

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1. What effect the overseas activity will have on the solvency of the U.S. bank;
2. What effect the overseas activity will have on the concentration of economic power;
3. What effect the overseas activity will have on the competitive position of U.S. banking organizations vis-a-vis their foreign competitors.

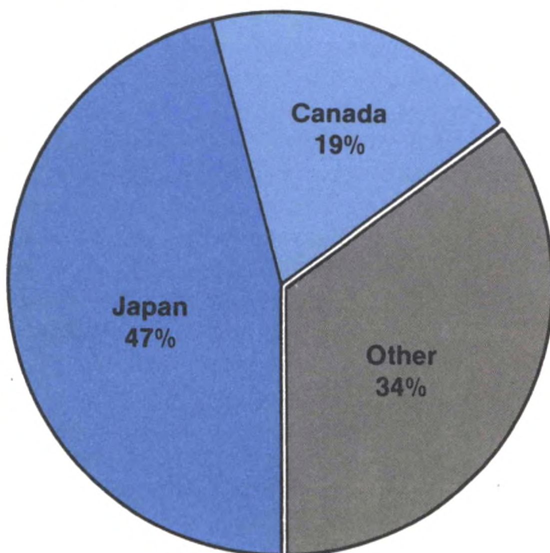
But the Board has the option of adopting either of two strategies in determining which activities will be allowable. The Board can require that the preponderance of evidence indicates *no* adverse effects associated with allowing the activity, or the Board can require that the preponderance of evidence does indicate adverse effects associated with allowing the activity. The first strategy obliges the Board to construct a list of permissible activities for U.S. banking organizations overseas. The second strategy obliges the Board to construct a proscribed list of activities.

The first strategy is, in fact, the one presently used. Based on an "approved list of activities" compiled by the Board, U.S. banking organizations overseas engage in activities that are allowed domestically only for nonbank subsidiaries of bank holding companies—for example, consumer finance and equipment leasing—and in activities that are not allowed domestically—examples are investment banking, venture capital financing involving substantial equity participations, and provision of warehousing services. These last-mentioned activities are permitted on the premise that they are usual for banks in particular foreign markets, and therefore, the benefit of allowing them offsets the incremental risk they pose to the soundness of the bank and the banking organization.

The Board has made it clear that some activities, such as general insurance underwriting, are not permissible. The Board's argument in these cases is that the activity is sufficiently different from those engaged in by banks in the United States—and is not a service commonly provided by banks in markets outside the United States—that it introduces an element of risk that does nothing to offset competitive disadvantages vis-a-vis foreign competitors in foreign markets. However, the fact that an activity is not allowable for a foreign banking organization in its own home market does not mean that the Board will prevent U.S. banking organizations in that market from engaging in that activity. For example, U.S. banking organizations in Canada can engage in leasing services, but Canadian law prohibits Canadian-chartered banks from doing so.

The Board also has indicated that it would turn down requests to approve overseas activities that involve a significant adverse impact on concentrations of economic power, even if the granting of approval would not endanger bank soundness nor violate statutory

## Canadian and Japanese banks account for two-thirds of U.S. foreign bank assets

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limitations. This, in fact, occurred when the Board denied the application of the Bank of America Corporation and the Allstate Insurance Company for a foreign joint venture. In its denial, the Board indicated:

> The Board was equally concerned with the fact that this application proposes a joint venture between the largest U.S. banking organization and one of the nation's largest insurance companies, which, as noted above, is wholly-owned by the largest retailer of general merchandise in the U.S. Close working relationships abroad between large U.S. banking organizations and large U.S. insurance companies could in time weave a matrix of relationships between the joint venturers in the U.S. and abroad that could lead to an undue concentration of economic resources in the domestic and foreign commerce of the United States. The Board concluded that such potentially adverse effects could result from the proposed application and that such potential effects would clearly not be consistent with the purposes of the Bank Holding Company Act, nor in the public interest.[5]

The strategy of the Board's constructing a proscribed list of activities may be referred to as "When in Rome do as the Romans do, BUT," which is to say that the Board passes regulatory jurisdiction over foreign operations of U.S. banking organizations to appropriate foreign regulatory bodies but reserves the right to proscribe those specific activities it deems objectionable. To be on the proscribed list, activities would have to fit into one of several categories:

1. Activities involving risks that are sufficiently different in a qualitative sense from those previously encountered by U.S. banks, both domestically and in international and foreign businesses, and that must be prohibited in the interest of averting potential threats to the solvency of the U.S. banking organization. A possible example of an activity in this category would be commodity speculation.
2. Activities that so violate traditional U.S. standards concerning separation of banking and commerce that they would clearly have an undesirable feedback on U.S. markets. As an example, it is within the realm of possibility that a U.S. banking organization's overseas interest in a foreign steel firm might adversely affect the bank's willingness and ability to serve the banking needs of U.S. manufacturers in the steel industry.
3. Activities involving U.S. banking organizations and U.S. or foreign business firms in joint ventures that either limit the access of other U.S. banking organizations to particular foreign markets or limit the access of foreign firms to the U.S. market. To avoid such joint ventures, the Board could provide a description of potential partners whose joining would be considered objectionable.

Of the two strategies, the first is rather cautious, the second rather liberal. The Board has the statutory authority to implement the second strategy and may do so when the evidence indicates that U.S. banking organizations require a freer rein in their overseas activities to compete effectively with foreign banks. The Board's current policy of following the strategy requiring the evidence to show no adverse effects from an activity indicates a desire to minimize the risks introduced to U.S. banking organizations by overseas activities.

[5] *Federal Reserve Bulletin*, July 1974, pp. 517-519.

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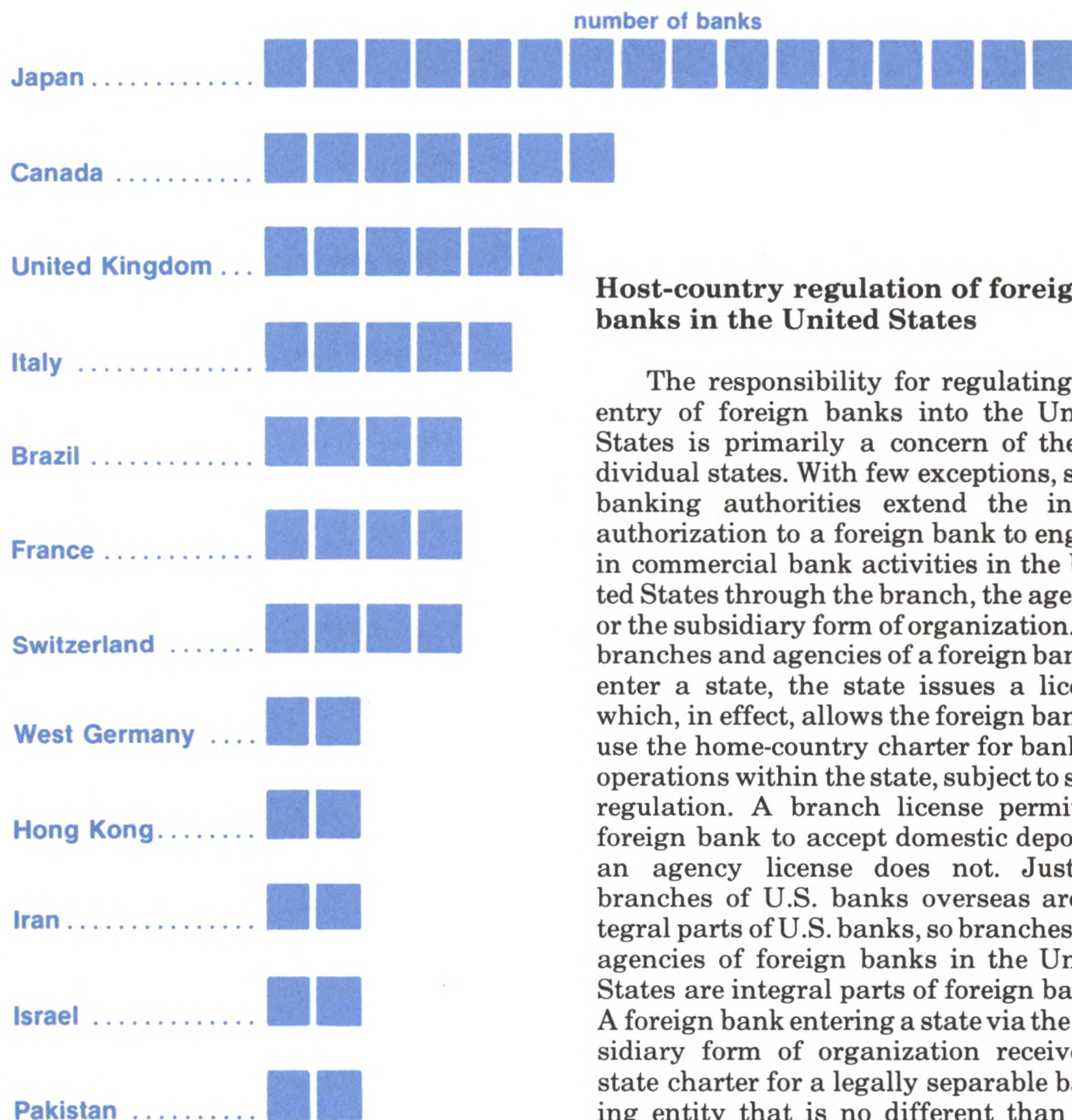
## Banks from 22 nations* are authorized to operate U.S. banking businesses




*There is one bank in the United States from each of the following nations: Argentina, Columbia, Greece, India, Korea, Mexico, the Netherlands, the Philippines, Singapore, and Thailand. There is also one joint-venture bank owned by banks of several western European nations.

### Host-country regulation of foreign banks in the United States

The responsibility for regulating the entry of foreign banks into the United States is primarily a concern of the individual states. With few exceptions, state banking authorities extend the initial authorization to a foreign bank to engage in commercial bank activities in the United States through the branch, the agency, or the subsidiary form of organization. For branches and agencies of a foreign bank to enter a state, the state issues a license which, in effect, allows the foreign bank to use the home-country charter for banking operations within the state, subject to state regulation. A branch license permits a foreign bank to accept domestic deposits; an agency license does not. Just as branches of U.S. banks overseas are integral parts of U.S. banks, so branches and agencies of foreign banks in the United States are integral parts of foreign banks. A foreign bank entering a state via the subsidiary form of organization receives a state charter for a legally separable banking entity that is no different than any other banking entity chartered by that state.

Among the privileges available to U.S.-chartered banks is having deposits insured by the Federal Deposit Insurance Corporation—a privilege not available to U.S. branches or agencies of foreign

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banks. As of mid-1974, only a few states allowed foreign banks access to their markets in any form. The most prominent states doing so are New York, California, and Illinois; prominent states which exclude access are Texas and Florida.

Under the Bank Holding Company Act of 1956 as amended in 1970, the Board of Governors of the Federal Reserve System acquired jurisdiction over certain U.S. activities of foreign banking organizations that have a U.S.-chartered bank subsidiary. The Board's jurisdiction involves restrictions that apply to these organizations as well as to U.S. bank holding companies. These restrictions disallow the control of U.S.-chartered banks in more than one state except where grandfathering privileges exist, and limit nonbank subsidiaries of both U.S. and foreign bank holding companies in the United States to the "permissible activities" listed by the Board (pursuant to Section 4(c)8 of the act). The Board does not have any jurisdiction over the branch of a foreign bank. A state may license a branch of a foreign bank even if that bank already has a branch in another state, or if the bank's nonbanking subsidiaries engage in what the Board lists as "nonpermissible" activities.

Three strategies for the federal regulation of the U.S. banking activities of foreign banking organizations are available:

1. Restrict the U.S. activities of foreign banking organizations to a set of banking and finance activities clearly related to servicing trade between the United States and other countries.
2. Allow the continuation of the current situation, where foreign banking organizations are largely ignored in federal banking statutes—that is, jurisdiction will continue to reside with the states.
3. Provide a federal statutory framework that would treat foreign banking

**Foreign banks in Chicago**

The Illinois Foreign Banking Office Act, approved in August 1973 and effective October 1, 1973, permits foreign banks to establish state-licensed branches in Chicago's "Loop," with banking powers equivalent to state-chartered banks. In the past year, 20 foreign banks have filed applications for branches with the Illinois Commissioner of Banks and Trust Companies, and 18 licenses have been issued.

Licensees include some of the largest and best-known multinational banks: Banque Nationale de Paris, Banque de l'Indochine (a part of the Suez group) and the Credit Lyonnais of France; Commerzbank and Dresdner Bank of Germany; the National Bank of Greece; Bank Leumi le Israel; Banca Commerciale Italiana; the Sanwa Bank and the Sumitomo Bank of Japan; Algemene Bank Nederland; Swiss Bank Corporation; Barclays Bank International, The Chartered Bank, Lloyds Bank International, and the National Westminster Bank of the United Kingdom; the European Banking Company, a branch of a U.K. merchant bank owned by seven major European banks; the Hongkong and Shanghai Bank of Hong Kong.

Applications are now pending from the Banco Real and the Banco do Brasil, both of Brazil.

Branches of foreign banks in Chicago had been preceded in recent years by state-chartered subsidiaries. The First Pacific Bank, a subsidiary of the Dai-Ichi Kangyo Bank of Japan, was chartered in 1971; and the Banco di Roma (Chicago), a subsidiary of the Banco di Roma of Italy, was chartered in 1972.

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activities in the United States in a manner equal to that in which U.S. banking organizations are treated domestically.

In assessing the impact that adopting any of these strategies will have, the following questions should be answered:

1. What will be the strategy's impact on the position of U.S. banking organizations and foreign banking organizations in the U.S. markets in which they compete?
2. What will be the strategy's impact on nonbanking competition in U.S. markets? That is to say, what would be the relationship between foreign banking organizations and foreign direct investors in the United States? One possibility is that the more liberal the access that foreign banking organizations have, the greater their ability to promote foreign direct investment in the United States and, consequently, the more significant the impact of foreign direct investors on the state of competition in the United States.
3. Will the strategy provide reasonable bank supervisory safeguards for the creditors of foreign banking organizations?
4. How will the strategy affect the treatment of U.S. banking organizations overseas by foreign banking regulators?

The Federal Reserve System's Steering Committee on International Banking Regulation has concluded that foreign banks in the United States should be treated in the same manner that domestic U.S. banks are treated—i.e., the principle of nondiscrimination or national treatment. The committee believes that this strategy provides for responsible regulation of foreign banking activities in the United States, while allowing foreign banking organizations to contribute healthy stimulation to U.S. markets. The Steering Committee is preparing legislation to implement this strategy.

*Allen Frankel*

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# Banking developments

## Treasury innovations and the banks

Some longstanding cash management practices of the Treasury Department are undergoing changes that are likely to have significant effects on the entire banking system. Already, calls on Treasury tax and loan accounts have been speeded up and the size of weekly U.S. Treasury bill financings is being keyed to more immediate needs. Further modifications are likely to follow from the findings of a recently completed study of Treasury tax and loan accounts. The study concluded that the value of Treasury tax and loan deposits to banks is now greater than the value of the services that banks supply to the Treasury in return for the deposits. At the very least, proposed changes will mean smaller average U.S. Treasury deposits in commercial banks.

### What are tax and loan accounts?

Treasury tax and loan accounts (TT&L accounts) are demand deposits that the Treasury holds at commercial banks. In 1973, these deposits averaged $4.9 billion. Of the nation's 14,368 banks, 13,693 were classified as special depositories entitled to hold Treasury deposits as of July 31, 1974.

The TT&L accounts are the first resting place for a large portion of government receipts. Most tax receipts flow into these accounts.* At times, banks are permitted to pay for all or part of their own and their customers' subscriptions to new government securities by crediting these accounts. Government funds remain in these accounts until needed and then are transferred to Treasury balance accounts at Federal Reserve banks, from which all government disbursements are made.

The TT&L accounts provide a means by which funds can be transferred from the general public to the Treasury and back again without seriously disrupting the nation's banking system and the money market. If funds were to flow directly and immediately from the public to the Treasury's Federal Reserve account—completely bypassing commercial banks—wide fluctuations in bank reserves (and thus in credit availability) would result because of the lack of synchronization between government receipts and expenditures. Government receipts would immediately drain reserves from the banks until the funds were returned to private deposits via government expenditures.

The existing TT&L account system moderates these potentially disruptive reserve effects. To the extent that Treasury balances at the Federal Reserve are kept at a constant level, flows between the government and the public are reflected in shifts between private deposits and Treasury deposits at commercial banks without affecting total loanable funds.

In the absence of TT&L accounts, any undesired effects of increases or decreases in Treasury deposits at the Federal Reserve could be offset by Federal Reserve open market operations on a very large scale. As an indication of the required amount, the Treasury's total operating balance (its balance at the Federal Reserve, the TT&L balances at commercial

*Currently eligible for credit to the TT&L accounts are: withheld income taxes, employer and employee social security taxes, railroad retirement taxes, a number of excise taxes, estimated and actual corporate income taxes, and federal unemployment taxes.

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banks, plus other miscellaneous demand balances) dropped from approximately $6.4 billion at the beginning of June 1974 to $2 billion on June 12, and then increased to $10.2 billion on June 20. Without TT&L accounts and based on a monthly average level of reserves of $36.4 billion, these swings in the operating balance would have first added approximately 12 percent to total reserves and then drained 22.5 percent from them.

### How TT&L accounts work

Commercial banks run a highly efficient tax collection system for the U.S. Government by helping to insure that receipts are available for Treasury use much more rapidly than would be the case under alternative collection systems. For example, a corporation can simply make its federal tax payments through its own bank, then the bank will debit the corporation's account and credit its own TT&L account. This eliminates delays due to check clearings and saves the Treasury the expense of handling a large volume of remittances.

Credits to TT&L accounts as payments for Treasury securities benefit both the government and the banks. One of the original purposes of a federal depository system was to provide an incentive for banks to serve as distributors of Treasury securities. This incentive is heightened when banks are allowed to pay for their purchases of new Treasury issues by crediting their TT&L accounts. The Treasury authorizes this means of payment only in financing operations where new cash is being raised. With this privilege, a bank can acquire an earning asset with no immediate drain on its reserves, although its required reserves increase because of the higher level of TT&L deposits. Of course, a number of days later, as calls are made on the TT&L accounts, the bank will lose reserves in an amount equal to the dollar value of the new securities it has purchased.

Because the TT&L credit is valuable, banks are often willing to outbid nonbank investors for a new issue when the privilege is granted. Consequently, banks usually take the lion's share of any offering when TT&L payment credits are allowed. For example, in each tax anticipation bill offering with TT&L privileges during the 1971-73 period, banks, on average, were awarded 93 percent of the total public allotments. In the process of outbidding other investors for new issues, the banks will sometimes purchase the new securities at rates below market. How far below the market, if at all, the Treasury can issue its debt depends on the estimated length of time banks will hold the new TT&L deposits and general market conditions.

By encouraging bank participation in Treasury financings, the banks have become, in effect, underwriters of government securities over the years and have developed a vast customer network. Thus, even when TT&L payment privileges are not granted, banks remain instrumental in the efficient distribution of new Treasury issues by providing advice to customers and handling their subscriptions.

Banks not only help the Treasury distribute its marketable debt, but its nonmarketable debt as well, specifically, savings bonds. Most banks stand ready to issue and redeem savings bonds and to assist businesses in setting up payroll savings plans. Banks and other financial institutions that act as paying agents for the redemption of savings bonds are reimbursed for these services at the rate of 15 cents for each of the first 1,000 bonds redeemed during the quarter and 10 cents for each bond in excess of 1,000. Although financial institutions receive no direct reimbursement for issuing savings bonds, commercial banks are implicitly compensated by earnings derived from TT&L account balances.

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## Effects of high interest rates

On several occasions over the years, studies have compared the value of the interest-free TT&L account deposits to banks with the costs of services provided by the banks. Studies completed in 1960 and 1964 concluded that banks, in the aggregate, were just about breaking even on their TT&L accounts, and if anything, were absorbing a loss. These conclusions were reversed in the 1974 study, largely because of the effects of high interest rates. Higher short-term rates provide a much greater earnings potential on TT&L balances. Moreover, it would appear that, in contrast to ten years ago, more banks are charging their customers for such Treasury-related services as cashing Treasury checks, handling subscriptions for new Treasury securities (other than savings bonds), and handling matured Treasury securities.

One of the principal objectives of the most recent study was to determine whether the earnings value of TT&L deposits exceeded the costs of the services provided to the Treasury by the banks. At the outset of the investigation it was decided that the only services for which the TT&L account itself should be considered compensation would be those directly related to handling these accounts, specifically, (1) the maintenance of the TT&L account and (2) the processing of federal tax deposits through the TT&L account.

On the basis of a survey of 600 banks, it was concluded that the aggregate earnings derived from TT&L accounts were far in excess of the costs of maintaining these accounts. The rate selected to measure the earnings value on the TT&L account was the average rate on new issues of 3-month Treasury bills during the five-year period ended December 31, 1972, which was 5.5 percent. This rate was adjusted downward to account for reserve requirements and FDIC assessments. Using earnings rates ranging between 4.51 percent and 5.06 percent, and extrapolating from the sample of responding banks to all banks holding TT&L accounts, the Treasury estimated that in 1972, aggregate net earnings for the banks that were attributable to TT&L accounts were over $300 million. Even after subtracting the costs of issuing and redeeming savings bonds, the estimated earnings were $260 million. It should be emphasized that while the study indicates that in the aggregate banks are recording net earnings on TT&L accounts, some individual banks may be incurring losses.

## Possible solutions

The Treasury has suggested a number of ways in which it might recapture some of these excess earnings. Among the cash management proposals under consideration are:

1. **Have banks pay interest on TT&L deposits:** this would require Congressional authority since the Banking Act of 1933 prohibits the payment of interest on demand deposits.
2. **Convert Treasury demand deposits to time deposits:** the problem with this approach is that according to Federal Reserve regulations, funds must be left on deposit for a minimum of 30 days if interest is to be paid. The average life of a TT&L deposit is about 10 days.
3. **Invest TT&L deposits in the money market on a day-to-day basis:** this, too, would require Congressional authorization. A possible drawback with this plan is that because of the large amount of funds involved, Treasury purchases of a specific instrument might create temporary rate distortions among the different money market instruments.
4. **Hold a greater proportion of the Treasury's operating balance at the Federal Reserve:** presumably the Federal Reserve would add to its port-

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folio of securities in order to offset the reserve drain caused by the redistribution of Treasury funds. In so doing, the Treasury's revenues would be increased since the Fed returns a portion of its earnings to the Treasury each year.

In addition to these proposals to increase the earnings of its idle cash balances, the Treasury has embarked on a program to more efficiently manage the overall size of its operating balance. Part of this program involves more frequent adjustments of bill offerings to better match the Treasury's borrowing to its actual cash needs. Failure to make such adjustments in the past have led to temporary but unnecessary buildups in Treasury balances.

**Implications for banks**

The Treasury's new cash management program will work in the direction of lowering the Treasury's interest-free demand deposits at commercial banks. To the extent that these balances are converted to time deposits, the cost of funds to the banks could rise on a net basis after adjusting for differences in reserve requirements. If the Treasury chooses to hold a greater proportion of its operating balance in its Federal Reserve account, then, assuming open market operations are conducted to offset the resulting reserve drain, government deposits will be replaced by private deposits. For the banking system as a whole, this is not likely to raise the cost of funds. However, there will probably be some distributional effects since reserves would be drained from banks all over the country as calls were made on the TT&L accounts, whereas the offsetting reserve injections would flow initially to the money market banks. Thus, the money market banks could stand to gain in the sense that their demand for federal funds might be reduced somewhat.

Another aspect of the Treasury's program involves a plan to compensate financial institutions on a direct fee basis for certain services performed for the government, such as sales and redemptions of savings bonds. As mentioned earlier, banks—as well as other financial institutions—are reimbursed a nominal amount for each savings bond redeemed by them. However, the Treasury's 1974 study indicates that this amount is far below the actual costs of processing these matured securities. Financial institutions currently receive no direct compensation for issuing savings bonds, although banks are assumed to be implicitly rewarded through their TT&L account earnings. Under the proposed arrangement, reimbursement for the issuance and redemption of savings bonds would be through fees at levels that closely reflect the actual costs incurred in processing these securities. These more realistic fees would enable the banks to recoup some of the earnings they would lose due to the change in the handling of TT&L accounts. A fee-basis compensation plan would also benefit those financial institutions that have not enjoyed TT&L account earnings but nevertheless have performed these valuable services. ■

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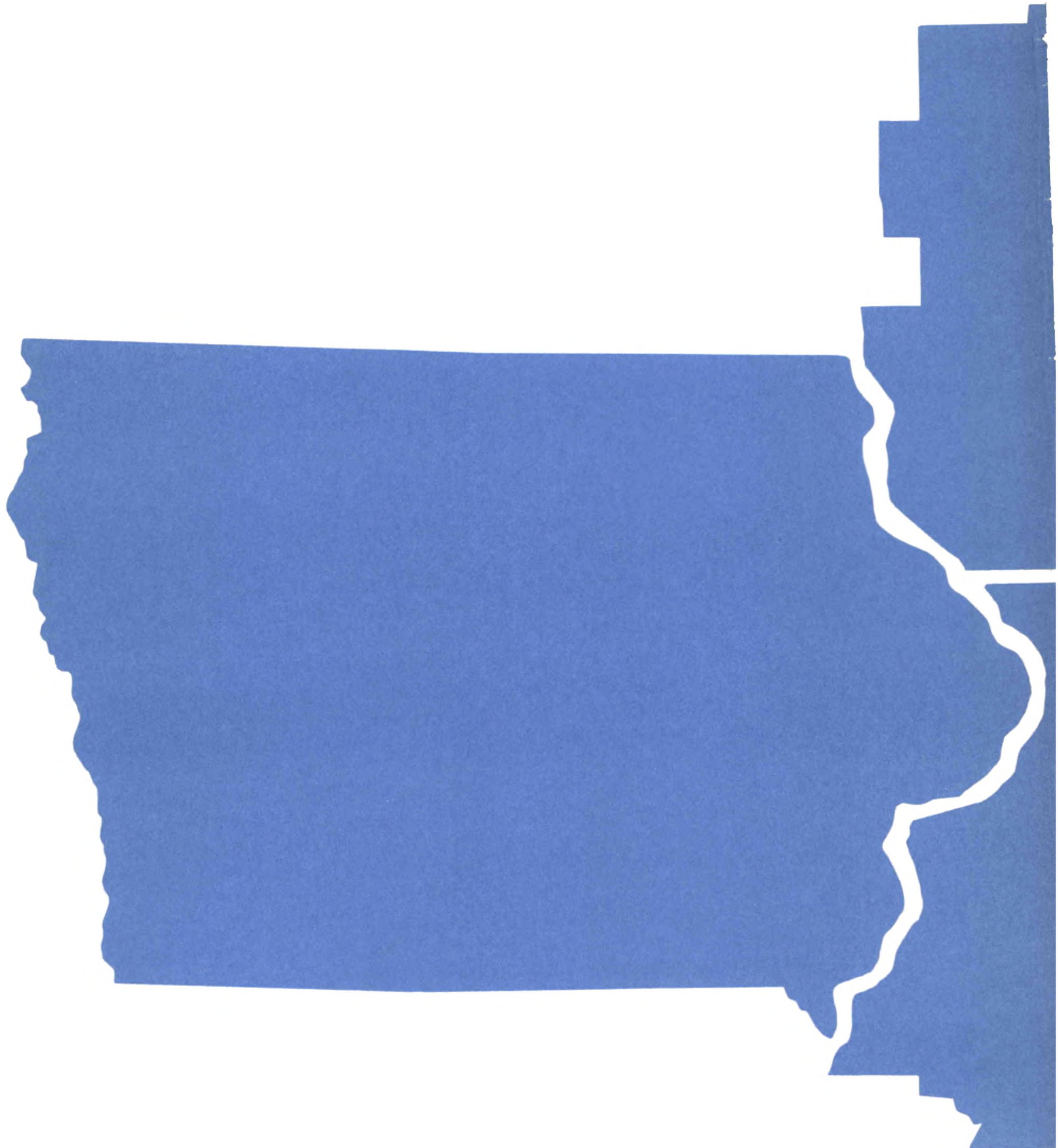

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