Senior Management Seminar -- Michigan

APRIL 26, 1979

FEDERAL RESERVE MEMBERSHIP AND THE CHANGING FINANCIAL ENVIRONMENT

I WOULD LIKE TO ADD MY PERSONAL WELCOME TO ALL OF YOU. I AM PLEASED THAT YOU HAVE TAKEN THE TIME TO MEET WITH US--HOPEFULLY NOT ONLY TO HEAR WHAT WE HAVE TO SAY BUT ALSO TO GIVE US THE BENEFIT OF YOUR COUNSEL ON THE MAJOR ISSUES CONFRONTING THE FEDERAL RESERVE SYSTEM.

I HAVE ALWAYS BEEN PARTICULARLY PROUD OF THE ROLE THAT MEMBER BANKS IN MICHIGAN HAVE PLAYED IN FEDERAL RESERVE SYSTEM AFFAIRS. YOU HAVE PROVIDED LEADERSHIP, NEW IDEAS AND, I MUST ADMIT, YOU HAVE OFFERED, NOT INFREQUENTLY, SOME INTERESTING CHALLENGES. I KNOW THAT THIS AFTERNOON AND EVENING WILL NOT BE ANY DIFFERENT. WE CAN EXPECT TO LEAVE WITH A KEENER APPRECIATION OF YOUR PROBLEMS AND NEW KNOWLEDGE ABOUT THE OPPORTUNITIES WE HAVE TO MAKE THIS UNIQUE PARTNERSHIP OF OURS EVEN MORE VITAL.

On the ball in recovery critical issue

AS THE PROGRAM INDICATES, THIS PARTNERSHIP--MEMBERSHIP IN THE FEDERAL RESERVE SYSTEM--IS WHAT I WANT TO TALK ABOUT. IT COMES FIRST ON THE PROGRAM BECAUSE IT IS THE MOST IMPORTANT ISSUE CONFRONTING ALL OF US.

Wisc bankers Bruce Horwitz disc at WBC.

THE OTHER PART OF MY TITLE--THE CHANGING FINANCIAL ENVIRONMENT--IS THERE BECAUSE THAT IS THE REASON WHY MEMBERSHIP HAS BECOME AN IMPORTANT ISSUE. IN A WORD, THAT CHANGING ENVIRONMENT IS COMPETITION--COMPETITION FROM NON-MEMBER BANKS, COMPETITION FROM OTHER NON-BANK FINANCIAL INSTITUTIONS AND COMPETITION FROM COMMERCIAL FIRMS.

WBA Share of market Convention S&L's

BANKS NO LONGER HAVE A MONOPOLY ON MONEY AND CREDIT--IF THEY EVER DID. THE POSITION OF OUR BANKS HAS BEEN STEADILY ERODED AS MARKET AFTER MARKET HAS BEEN INVADED OR PRE-EMPTED.

But it could help (S.85)

I WOULD BE FOOLISH, OF COURSE, TO ARGUE THAT APPROPRIATE MEMBERSHIP LEGISLATION WOULD CHANGE THE ENTIRE COMPETITIVE POSITION. IT CAN'T. THERE ARE OTHER VERY IMPORTANT REGULATORY AND LEGISLATIVE IMPEDIMENTS THAT INFLUENCE WHAT YOUR BUSINESS CAN BE AND HOW AND WHERE YOU CONDUCT YOUR BUSINESS.

But removal of the inequities associated with reserve balances are an important step in the right direction.

Almost everyone, even non-member banks and savings and loans, agree that the loss of members in the Fed is a serious matter. It strikes at the very heart of this unique Central Bank--based on a regional structure (the importance of which should never be discounted) and relatively independent of day to day political pressures. While there are disagreements as to the monetary policy actions we have taken, the <u>concept</u> of an institution with one foot planted in the government sector and the other planted in the private sector, is accepted and encouraged as consistent with our deepest political philosophies.

There is no doubt that the loss of membership is a direct result of the cost of holding reserves at the Fed. Those costs have become relatively greater as access to Fed services have been provided to non-member banks. I know that you have argued that we have exacerbated the membership problem by allowing this to happen. But let me remind you and emphasize the point that Justice Department pressures for providing access to all are very, very real.

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Another factor that has complicated the membership issue and has the potential for further, severe, exacerbation of the problem has been the pressures for pricing Fed services. On the grounds of economic or allocative efficiency, academics, government and even the banking industry itself have argued for pricing. We have remained steadfast in our commitment not to price until the inequities of membership are resolved.

Far more complicated

But what then is the solution? First, there has been the argument that we should reduce reserve requirements within our current statutory limitations. That simply won't correct the problem. The smaller banks would gain almost nothing since they are already at the minimums. And the

GAIN FOR LARGE BANKS SIMPLY WILL NOT FLY IN CONGRESS. IT WOULD BE CONSIDERED A LARGE BANK GIVEAWAY. IF YOU DON'T BELIEVE ME JUST READ SOME OF THE TESTIMONY IN CONGRESS. THE VITRIOLIC COMMENT IS MUCH MORE THAN POSTURING.

ANOTHER SOLUTION WOULD BE STRAIGHT FORWARD UNIVERSAL RESERVE REQUIREMENTS. CONGRESS HAS NEVER BOUGHT THIS AND NEITHER HAVE THE BANKING AND THRIFT INDUSTRIES BEEN VERY SUPPORTIVE OF THIS CONCEPT.

MOST OF THE OTHER MEMBERSHIP PROPOSALS COMING FROM INDUSTRY GROUPS OR ORIGINATING FROM MEMBERS OF CONGRESS ARE COMPROMISES ON UNIVERSAL RESERVE REQUIREMENTS. I KNOW THAT BY NOW THERE SEEM TO BE SO MANY DIFFERENT PROPOSALS THAT EVERYONE IS CONFUSED. BUT THE ESSENTIAL ASPECTS ARE NOT AS CONFUSING AS THEY APPEAR. THERE ARE TWO IMPORTANT DISTINGUISHING CHARACTERISTICS OF THE PROPOSALS. FIRST, SHOULD THERE BE MANDATORY OR VOLUNTARY RESERVE REQUIREMENTS? (BY THE WAY, NONE OF THE PROPOSALS HAS EVER INCLUDED MANDATORY <u>MEMBERSHIP</u>. SO, PLEASE, WHEN YOU SEE PROPOSALS THAT DEFINE ALL DEPOSITORY INSTITUTIONS AS BEING <u>SUBJECT TO RESERVE REQUIREMENTS</u> DON'T READ THIS AS REQUIRING FEDERAL RESERVE MEMBERSHIP.)

Realize there is little difference

THE OTHER MAJOR CHARACTERISTIC OF THE PROPOSALS DEALS WITH WHO IS COVERED AND ON WHAT TYPES OF DEPOSITS. THE VOLUNTARY RESERVE REQUIREMENT PROPOSALS COVER ONLY COMMERCIAL BANKS AND IMPOSE RESERVE REQUIREMENTS ON THE TRADITIONAL DEPOSIT FORMS IN BANKS THAT ARE MEMBERS. THE MANDATORY RESERVE REQUIREMENT PROPOSALS PLACE REQUIREMENTS ON THE TYPE OF DEPOSIT--TRANSACTION ACCOUNTS--AT ALL DEPOSITORY INSTITUTIONS AND WITH AN EXEMPTION OF $35, $40 OR $50 MILLION ON TRANSACTION ACCOUNTS AND A SIMILAR EXEMPTION ON TIME AND SAVINGS ACCOUNTS.

YOU MAY ALSO FIND THE FED'S POSITION ON THESE VARIOUS BILLS CONFUSING. I THINK I CAN SORT THAT OUT FOR YOU. BUT BEFORE I DO, LET ME ASK YOU--HOW MANY BANKS HERE HAVE TOTAL DEPOSITS OF UNDER $75 MILLION?

None of you would have a required reserve balance at the Fed if the latest version of the Reuss bill were to pass. This Bill is in mark-up today and provides for a $70 million exemption and initial reserve requirements of 7 percent for transaction and short-term time accounts and 1 percent on savings and long-term time accounts. Only 14 of the member banks in Michigan would have balances at the Fed and for those 14 banks, total reserves would be reduced more than $425 million. (Only 5 current non-member banks would have required balances at the Fed.)

on the other name

Draft S85

HR7 Supp Reserves Int.

So--from the standpoint of the cost of reserves, the gain is large for all of you. And if reserve cost is the reason for the loss of membership, would all of you stay in the System and support this latest version?

Of course, I know that there are other issues--probably more philosophical than pocket book. And I know that in a perfect world without any constraints perhaps a better solution could be found. But there are constraints!

Let me tell you something about the constraints and the Fed's position.

Most important to the Fed is the concept that we should have similar treatment of the same type of deposits at all institutions--savings and loans, credit unions, etc. This goes back to the original issue I raised--equitable competition. The issue is not only equity among banks but among financial institutions in the same activities. It is important to get this concept established. Competition is growing with S&Ls, credit unions and others. The clock won't be turned back. So why have your hands tied?

Similar treatment also makes sense in terms of monetary control. Shifts among institutions with different reserve ratios on similar types of deposits creates errors in prediction and control of money and credit. The reserve ratio itself is not the major problem, it is the proportion of

THE DEPOSITS COVERED BY A KNOWN AND STABLE RESERVE REQUIREMENT. YOU ALL KNOW THAT RESERVE RATIOS ARE THE FULCRUM CONNECTING RESERVES AND MONEY. SHIFTS FROM RESERVABLE TO NONRESERVABLE INSTITUTIONS CAUSE LARGE ERRORS IN PREDICTION. NOW WITH ABOUT 71 PERCENT OF DEPOSITS RESERVABLE, THE ERROR FROM SHIFTS AMOUNTS TO PLUS OR MINUS 3 1/2 PERCENT IN M-1.

WHY NOT VOLUNTARY RESERVES? MANY OF US CAN GIVE GOOD REASONS FOR MAINTAINING A VOLUNTARY RESERVE REQUIREMENT POSTURE. BUT THERE ARE SEVERAL THINGS TO CONSIDER. FIRST, IS THE IMPORTANCE OF ESTABLISHING THE CONCEPT OF SIMILAR REQUIREMENTS FOR ALL INSTITUTIONS--AS I MENTIONED EARLIER. A FAILURE TO DO THIS WILL LEAVE THIS UNFAIR COMPETITION UNTOUCHED.

BUT EVEN IF THAT CONCEPT OF INEQUITY COULD BE IGNORED, I THINK THAT WE SHOULD PAUSE FOR A MINUTE AND ASK OURSELVES WHAT WOULD BE REQUIRED TO MAKE A VOLUNTARY APPROACH WORK. WHAT WOULD BE REQUIRED TO KEEP MEMBERSHIP INTACT OR GROWING? RESERVE REQUIREMENTS WOULD HAVE TO BE REDUCED SIGNIFICANTLY, ACCESS LIMITED COMPLETELY TO MEMBERS, NO PRICING OR, IF PRICING, PAYMENT OF INTEREST ON RESERVES. THAT IS A FORMIDABLE PACKAGE TO GET AGREEMENT ON IN CONGRESS.

RIGHT AT THE TOP, WE WOULD HAVE TO ARGUE THAT ACCESS AND PRICING ARE ISSUES THAT ARE NOT REALLY DEBATABLE IN A POLITICAL SENSE. THE JUSTICE DEPARTMENT HAS ALREADY EMPHASIZED THE NEED FOR ACCESS AND ON PRICING EVEN MEMBER BANKS ARE PUSHING IN THAT DIRECTION.

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Both include
PRICING

IN THE WORLD OF ACCESS AND PRICING THEN, RETENTION OF A STRONG VOLUNTARY MEMBERSHIP MUST REQUIRE LARGE REDUCTIONS IN RESERVE REQUIREMENTS, PAYMENT OF INTEREST ON RESERVES OR A SIMILAR TYPE OF INDUCEMENT. FRANKLY, AND I THINK OBVIOUSLY FROM THE DEBATE YOU HAVE HEARD, THE TREASURY IS UNWILLING TO ACCEPT THE LOSS OF REVENUES THAT WOULD OCCUR <u>AND</u> CONGRESS REFUSES TO DO SO. I QUOTE "HOW COULD WE SUPPORT THIS NEW PROGRAM TO HAND OUT HUNDREDS OF

DAN
Doyle's
comments

millions of dollars of money from the Treasury to the banks. It's really welfare for the banks, subsidy for the banks, etc., etc., etc."

Now I know how you feel about this. I fully appreciate your position. I'm just indicating the facts of life. This is the realism we have to live with.

And similarly it appears that we are foreclosed from unilaterally paying interest on deposits. We may have different legal opinions. But Congress can and apparently would act to knock it down.

There is another area of realistic constraint that required a compromise. That was in the area of putting reserve requirements on time and savings accounts at thrifts. Equity demands it but political pressures from thrifts make it impractical. But the compromise in this area is looking better all of the time. The newest version of the Reuss bill sets a reserve requirement range on savings and long-term time deposits of 0 to 3 with 1 percent indicated as the initial percent. Would it be too bold to say, equity is coming?

All in all, then, there may be a workable alternative in the offing. Not perfect, but gauging the pressures on all sides, a reasonable approach.

What are the chances for success? As the hands raised earlier by this group might suggest, the reserve requirement burden will be lifted for most banks and sharply reduced for the few remaining. I don't know what the ABA will do. The IBAA position taken earlier should hold since the bills are similar. 340 20

7/20

And what about Congress? Well, the changes in the Reuss bill are to be proposed by Congressmen Moorhead and Barnard. Last time around Moorhead voted against H.R.7 and Barnard voted present. It looks as though it will get out of Committee.

9/20 ABA Leadership Conference

9/26 Volcker Senate Bk Com

NOW, I HAVEN'T GONE INTO ALL THE DETAILS ON THE NEWEST VERSION, LARGELY BECAUSE I DON'T KNOW HOW THINGS WILL ACTUALLY TURN OUT TODAY. BUT THERE ARE OTHER ELEMENTS AS WELL THAT SHOULD IMPROVE THE ACCEPTABILITY OF THE PROPOSAL. A TEN-YEAR PHASE-IN FOR NON-MEMBERS SHOULD MAKE IT MORE PALATABLE TO SOME. ALLOWING THE EXEMPTION UNUSED ON TRANSACTION ACCOUNTS TO BE APPLIED TO TIME AND SAVINGS WOULD BE A PLUS TO SOME. AND THE ADDITION OF FLOAT TO THE PRICING SCHEDULE--ALTHOUGH THAT WILL BE A BIG PROBLEM--HAS ATTRACTED SOME OTHER BANKS.

THE NEED FOR RELIEF OF THE COST OF MEMBERSHIP IS UNQUESTIONABLE. WE WILL MAKE PROGRESS THIS YEAR--WE MUST.