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TO THE EXECUTIVE BANK MANAGEMENT SEMINAR
MILWAUKEE, WISCONSIN
SEPTEMBER 26, 1979

FEDERAL RESERVE MEMBERSHIP AND THE CHANGING FINANCIAL ENVIRONMENT

I WOULD LIKE TO WELCOME ALL OF YOU TO OUR SEMINAR THIS AFTERNOON. WE ARE 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 AND PROBLEMS CONFRONTING ALL OF US IN THE FEDERAL RESERVE SYSTEM.

MEMBER BANKS IN WISCONSIN HAVE ALWAYS PLAYED A VERY ACTIVE ROLE IN FEDERAL RESERVE AFFAIRS. YOU HAVE OFFERED LEADERSHIP, NEW IDEAS AND, I MUST ADMIT, SOME VERY INTERESTING AND WORTHWHILE CHALLENGES TO THE WAY WE DO OR SHOULD DO BUSINESS WITH YOU. I KNOW THAT TODAY WILL NOT BE ANY DIFFERENT. WE 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 SUCCESSFUL.

AS THE TITLE IN THE PROGRAM INDICATES, THIS PARTNERSHIP--MEMBERSHIP IN THE FEDERAL RESERVE SYSTEM--IS WHAT I WANT TO TALK ABOUT. IT IS FIRST ON THE PROGRAM BECAUSE IT IS THE MOST IMPORTANT ISSUE CONFRONTING US. WHILE THE LACK OF SUCCESS SO FAR IN SOLVING THIS PROBLEM IS FRUSTRATING TO ALL OF US, WE CANNOT GIVE UP SINCE IT FUNDAMENTALLY CONCERNS THE SURVIVAL OF AN INSTITUTION AS WE HAVE KNOWN IT.

THE OTHER PART OF MY TITLE--THE CHANGING FINANCIAL ENVIRONMENT REFERS TO WHAT I CONSIDER TO BE THE MAJOR REASON FOR THE MEMBERSHIP PROBLEM. IN A WORD, THAT CHANGING ENVIRONMENT IS COMPETITION--THE GROWTH OF COMPETITION

FROM NON-MEMBER BANKS, COMPETITION FROM OTHER NON-BANK FINANCIAL INSTITUTIONS AND EVEN COMPETITION FROM COMMERCIAL FIRMS. YOU ALL RECOGNIZE COMPETITION AS A CRITICAL ISSUE. THE WISCONSIN BANKERS ASSOCIATION HAS CLEARLY FOCUSED ON IT. I WAS, FOR EXAMPLE, IMPRESSED WITH THE REPORTS I RECEIVED ON THE OUTSTANDING PANEL DISCUSSION THAT BRIAN KOONTZ SET UP AT THE LAST CONVENTION.

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

IT IS OBVIOUS THAT THIS COMPETITION HAS BEEN A MAJOR REASON WHY MORE AND MORE BANKS HAVE REASSESSED THE COSTS AND BENEFITS OF MEMBERSHIP. WHILE THERE MAY BE OCCASIONAL CONVERNS ABOUT SUPERVISORY, REGULATORY OR OPERATIONAL MATTERS, THE LOSS OF MEMBERSHIP IS A DIRECT RESULT OF THE COST OF HOLDING RESERVES AT THE FED. THOSE COSTS HAVE BECOME RELATIVELY GREATER AS COURTS HAVE REQUIRED THAT FED SERVICES BE PROVIDED TO OTHERS AS WELL. A CHARGE AT LEAST PARTIALLY OFFSET BY SERVICES HAS TAKEN ON MORE OF THE CHARACTER OF A TAX—UNEQUALLY LEVIED.

I AM, OF COURSE, PARTICULARLY SENSITIVE TO THE ACCESS ISSUE HERE IN WISCONSIN. BUT LET ME EMPHASIZE THAT WE HAVE NOT SEARCHED OUT OPPORTUNITIES TO BROADEN SERVICES TO OTHERS. LEGAL PRESSURES--JUSTICE DEPARTMENT PRESSURES--TO PROVIDE ACCESS TO ALL ARE VERY, VERY REAL.

I WOULD BE FOOLISH, OF COURSE, TO ARGUE THAT LEGISLATION THAT CORRECTS THE INEQUITY IN RESERVE BURDENS WILL OFFSET FULLY THE UNCOMPETITIVE POSITION YOU ARE IN. IT CAN'T. THERE ARE OTHER VERY IMPORTANT REGULATORY AND LESISLATIVE IMPEDIMENTS THAT INFLUENCE WHAT YOUR BUSINESS CAN BE AND HOW AND WHERE YOU CONDUCT IT. BUT REMOVAL OF RESERVE BALANCE INEQUITIES WOULD BE A 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 WITH OUR MONETARY, SUPERVISORY AND REGULATORY POLICIES, THE CONCEPT 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.

BUT WHILE MEMBERSHIP HAS BEEN RECOGNIZED AS IMPORTANT, SOLUTIONS HAVE BEEN FRUSTRATED BY A NUMBER OF ELEMENTS. MOST PROMINENT HAS BEEN THE POLITICAL STRENGTH OF THE NON-BANK FINANCIAL INSTITUTIONS--S AND LS, CREDIT UNIONS AND OTHERS--WHO STAUNCHLY REFUSE TO SEE ANY EROSION OF THEIR COMPETITIVE POSITION. THE INORDINATE CONCERN OF A CONGRESS UNWILLING TO SEE REVENUES REDUCED IS ANY FACTOR. AND EQUALLY IMPORTANT BUT FAR MORE SUBTLE IS THE CHANGING PERCEPTION OF THE FED--WHAT IT IS AND WHAT IT SHOULD DO--ON THE PART OF MANY IN CONGRESS AND THE PUBLIC GENERALLY.

SOMEONE SUGGESTED TO ME RECENTLY THAT THIS PARTNERSHIP OF OURS IS SUFFERING FROM "MID-LIFE" CRISES. JUST OVER 55 YEARS OLD, IT HAS REACHED THIS STAGE SOMEWHAT LATER THAN A HUMAN BUT, NEVERTHELESS, IS HAVING DIFFICULTY WITH "IDENTITY" IN A CHANGING WORLD.

I HAVEN'T FELT A LOSS OF "IDENTITY" BUT CERTAINLY OUR ROLES AND RESPONSIBILITIES HAVE CHANGED AS A RESULT OF ACTIONS IN THE HALLS OF CONGRESS. CONGRESS HAS MANDATED A WHOLE NEW ROLE FOR THE FED IN CONSUMER ORIENTED PROGRAMS. CONGRESS HAS ADDED NEW REGULATORY DIMENSIONS IN THE HOLDING COMPANY AREA AND MORE RECENTLY IN INTERNATIONAL BANKING. CONGRESS HAS SPECIFIED A NEW REPORTING ROLE FOR MONETARY POLICY IN THE HUMPHREY-HAWKINS ACT. CONGRESS IS MOVING TOWARD INVOLVEMENT IN OUR PAYMENTS MECHANISM ACTIVITIES BY

PROPOSING PRICING. AND EVEN OUR FISCAL AGENCY FUNCTIONS HAVE BEEN MODIFIED AS A RESULT OF CONGRESSIONAL DECISIONS.

IT IS NOT SURPRISING THEN THAT MANY HAVE COME TO THE CONCLUSION THAT THE FED IS OR SHOULD BE STRICTLY A PUBLIC BODY. WITH THE DELICATE PUBLIC-PRIVATE BALANCE SET BY THE FOUNDING FATHERS FALTERING, THE MEMBERSHIP CONCEPT HAS UNFORTUNATELY BEEN RELEGATED TO A LESSOR OR EVEN NOMINAL ROLE BY THOSE WHO DO NOT UNDERSTAND THE STRENGTH OF THE FEDERAL RESERVE SYSTEM.

THERE IS NO DOUBT IN MY MIND THAT MEMBERSHIP IS OF PRIMARY IMPORTANCE TO ALL OF MY COLLEAGUES IN THE FEDERAL RESERVE SYSTEM. THE SEARCH IS FOR A SOLUTION THAT PRESERVES THIS VALUABLE ASPECT OF THIS INSTITUTION—RECOGNIZING THE REALITIES OF THE WORLD IN WHICH WE LIVE.

AND THE SEARCH IS STILL GOING ON. AS YOU KNOW A MEMBERSHIP BILL HAS PASSED THE HOUSE (H.R.7). PROXMIRE'S COMMITTEE BEGINS HEARINGS TODAY ON S.85. CHAIRMAN VOLCKER HAS MET WITH THE ABA LEADERSHIP GROUP AND RECEIVED SUPPORT FOR A SUPPLEMENTAL RESERVE REQUIREMENT ON WHICH A MARKET RATE OF INTEREST WILL BE PAID. THERE ARE STILL MANY PROPOSALS BY MANY DIFFERENT GROUPS IN THE WINGS. THERE IS NO WAY FOR ME OR FOR ANYONE ELSE TO BE CERTAIN AS TO THE OUTCOME, BUT IT SEEMS TO ME THAT A WORKABLE ALTERNATIVE MUST EMERGE. NOT PERFECT, BUT GAUGING THE PRESSURES ON ALL SIDES, A RESONABLE APPROACH.

I REALIZE THAT YOU HAVE PERHAPS FOUND THE FED'S POSITIONS ON THE MANY PROPOSALS THAT HAVE SURFACED TO BE CONFUSING. LET ME TELL YOU SOMETHING ABOUT THE FED'S POSITION AND THE CONSTRAINTS ON A SOLUTION TO MEMBERSHIP BY LEGISLATION.

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 flucrum connecting reserves and money. Shifts from reservable to nonreservable institutions cause large errors in prediction. Now with about /3 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.

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 AND CONGRESS REFUSES TO DO SO. I QUOTE "HOW COULD WE SUPPORT THIS NEW PROGRAM TO HAND OUT HUNDREDS OF 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 IMPORTANT AND CRITICAL AREA OF CONSTRAINT THAT CONTINUES TO REQUIRE A COMPROMISE. THAT IS THE EXTENT TO WHICH RESERVE REQUIREMENTS CAN BE PLACED ON THRIFT INSTITUTIONS. EQUITY DEMANDS IT BUT POLITICAL PRESSURES FROM THE THRIFTS MAKE IT DIFFICULT.

AS YOU KNOW UNDER THE INITIAL PROVISIONS OF H.R.7 AS PASSED ON JULY 20, ONLY MEMBER BANKS ARE COVERED WITH A 3 PERCENT RESERVE REQUIREMENT ON THE FIRST $35 MILLION IN TRANSACTION ACCOUNTS AND 11 PERCENT OF TRANSACTIONS ACCOUNTS OVER $35 MILLION. IT IS NOT UNTIL THE TRIGGER IS REACHED (MEMBER BANK DEPOSITS LESS THAN 67.5 PERCENT OF TOTAL DEPOSITS) THAT THRIFT INSTITUTIONS ARE COVERED ON TRANSACTION ACCOUNTS. (NO RESERVE REQUIREMENTS ARE PROPOSED FOR TIME AND SAVINGS DEPOSITS AT ANY INSTITUTION.) AND EVEN THEN WITH A REVERSION TO THE $35 MILLION EXEMPTION NO S&LS AND ONLY SEVEN MSBS

HAVE TRANSACTIONS BALANCES ABOVE \$35 MILLION AND THESE SEVEN WOULD MEET THEIR REQUIREMENTS WITH VAULT CASH.

THERE IS A WIDESPREAD VIEW THAT EVEN THOUGH MEMBER BANK RESERVES REQUIREMENTS WOULD BE CUT SHARPLY--ONLY 7 WISCONSIN MEMBER BANKS WOULD HAVE RESERVE BALANCES WITH US--THE TRIGGER WOULD BE REACHED QUICKLY AND THRIFTS WOULD BECOME SUBJECT TO RESERVE REQUIREMENTS. IN FACT IT COULD BE ARGUED THAT SINCE THE 3 PERCENT REQUIREMENT ON THE FIRST 35 MILLION WOULD BE ELIMINATED FOR MEMBER BANKS, THERE WOULD BE AN INCENTIVE TO LEAVE THE SYSTEM TO REDUCE REQUIREMENTS FOR ALL.

THE SENATE BILL S.85 HAS NO EXEMPTION FOR TRANSACTION BALANCES AND APPLIES A RESERVE RATIO ON ALL NONPERSONAL TIME DEPOSITS ABOVE \$4 MILLION. AS A CONSEQUENCE MANY THRIFT INSTITUTIONS ARE COVERED. ABOUT 780 S&LS AND MSBS WOULD HAVE REQUIRED RESERVES AND MORE THAN 230 WOULD HAVE RESERVE AT THE FED.

IN TERMS OF EQUITY, THERE WOULD BE AN IMPROVEMENT FROM S.85. BUT IN TERMS OF RESERVE COSTS IT WOULD BE HIGHER TO THE BANKS WITH 3 PERCENT UNDER \$5 MILLION AND 12 PERCENT OVER \$5 MILLION ON TRANSACTION ACCOUNTS AS WELL AS THE 6 PERCENT RESERVE COST OVER \$5 MILLION ON NONPERSONAL TIME ACCOUNTS.

HOW THE COMPROMISE BETWEEN THESE TWO POSITIONS (H.R.7 AND S.85) WILL WORK OUT IS VERY HARD TO TELL. IT SEEMS LIKELY THAT BOTH BANKS AND THRIFTS WILL BE LESS THAN ENTHUSIASTIC ABOUT THE COSTS OF S.85. BUT THE GENERAL SHAPE OF THE COMPROMISE APPEARS TO BE TAKING PLACE--A SIGNIFICANT REDUCTION IN RESERVE REQUIREMENTS FOR MEMBER BANKS AND AN EXTENSION OF SIMILAR RE-SERVE REQUIREMENTS TO THRIFTS FOR THE SAME TYPE OF ACCOUNTS.

AS I INDICATED EARLIER, THE SOLUTION WON'T BE PERFECT, BUT IT WILL AT LEAST FOCUS ON THE TWO ISSUES OF EQUITY AND COMPETITION THAT CONCERN ALL OF US.