Research Department
Federal Reserve
Bank of
San Francisco

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Business & Financial Letter

Checking-Account Interest

The Senate will come back from vacation after Labor Day, to decide the fate of a bill that would permit depository institutions nationwide to pay interest on consumer checking-type accounts (NOW accounts) and to receive interest on their required reserve balances. The bill was recently approved by the Senate Banking Committee, and if it passes the Senate, will go next to the House for further deliberation. Yet whatever its fate, this proposed piece of legislation draws attention to the gradual erosion of the generation-old prohibition against payment of interest on commercial-bank demand deposits.

The erosion process became evident in 1972, when the Massachusetts Supreme Court ruled that state law did not prohibit mutual savings banks from offering "negotiated orders of withdrawal" from savings accounts. Within a year, savings banks in both Massachusetts and New Hampshire began offering NOW accounts, and soon thereafter Congress redressed the competitive balance by allowing commercial banks in those states to offer NOW accounts also. Similar developments occurred in neighboring states, and NOW accounts today are available to individuals, nonprofit organizations and proprietorships throughout New England.

On another front, many money-market funds have been aggressively marketing interest-paying consumer accounts during the past several years. These funds not only pay interest—sometimes tax-exempt interest—but they offer checkwriting arrangements through commercial banks as well.

Implicit vs. explicit

As a means of avoiding the prohibition enshrined in the Banking Act of 1933, commercial banks have long paid *implicit* interest in the form of subsidized (or free) check and deposit transactions, convenient locations, and other consumer services. But with the rise in short-term interest rates over the past decade, many consumers would prefer *explicit* interest. Increasingly they have been moving their transactions balances (and savings accounts) out of banks and into other institutions. To provide for more even-handed competition for consumer balances, the Administration and the Federal Reserve developed the NOW-account legislation which (with some revisions) is now wending its way through the Senate.

The proposal for a nationwide spread of NOW accounts has stirred extensive debate over the possible impact this will have on various types of financial institutions. But

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the subject also raises a number of more fundamental issues regarding competition for consumer balances, tax status of transaction balances, and the implementation of electronic funds-transfers.

Competitive effects

How might interest on checking accounts affect competition in the market for transaction balances? Banks would begin to pay explicit interest for balances, and accordingly reduce (or perhaps eliminate) implicit interest they now pay in the form of free services. But more subtle changes would also occur. Commercial banks and other financial institutions would all compete for these balances under generally similar rules. Thus, these institutions would come to resemble each other more, both in their customer base and in their product lines. The effect would be greater competition.

A further impact would be felt by those institutions which have formerly attracted customer deposits by investing heavily in fixed factors such as attractive buildings—the proverbial temples of finance. With a shift to explicit interest, these institutions would find themselves with costly overhead in a world which puts less value on this means of attracting deposits. Many types of institutions could be affected—small banks and thrifts in nonbranching states, and perhaps even more, the large branch systems in states that permit them.

Unbundling and taxes

Most observers agree that a large portion of commercial-bank consumer demand deposits have traditionally been money-losers. (In part, banks have used checking accounts to attract savings deposits and other consumer business.) If nothing else changes, payment of interest on checking (NOW) accounts would increase such losses. Therefore, banks introducing NOW accounts would probably move more rapidly than they already have to "unbundle" the price structure of bank services. While paying interest on transaction balances, banks would simultaneously charge more for each transaction than they do now. Unbundling should lead to greater efficiency in bank operations as well as in consumer decisions. Consumers would have to pay for each portion of the package that they purchase, and would face prices that are more representative of true economic costs.

However, the combination of NOW accounts and charges on transactions could increase the tax bite on the consumer. Consider a simple illustration. Consumers held $80 billion in demand deposits in 1976. These deposits earned free services, which we could assume were worth about $4 billion at 5-percent interest. Obviously no income taxes were paid on the $4-billion implicit interest. Suppose instead that the $80 billion had earned 5-percent explicit interest and that consumers had been charged an equivalent $4 billion in transaction charges. Without taxes, consumers would have experienced the same net effect under either scheme, but with taxes the effect would have been different, because of the additional $4 billion in taxable income from explicit interest.

At an average 35-percent marginal rate on the sum of federal, state, and local income taxes, consumers would have been taxed $1.4 billion. Alternatively, consumers who were originally earning 5-percent implicit interest would have earned explicit interest *after taxes* of only 3.25 percent (65 percent of 5 percent), which compares unfavorably with the 5-percent service charge they would have to pay. Thus, in an effort to avoid taxes, consumers might lean toward the present system of implicit interest rather than the more efficient system of explicit interest and unbundling. Each consumer will choose the more attractive form of transaction. This suggests that NOW accounts may not overwhelm traditional checking accounts, and that the tax consequences may not be as adverse as the example suggests.

EFT effects

The issue of electronic funds transfer is separable from the payment of explicit interest on transaction balances, but the two are bound to affect one another. Interest on transaction balances, to the extent that it encourages unbundling of bank charges could tend to stimulate EFT. To date, EFT has not received widespread consumer acceptance, partly because consumers today are not charged directly for their transactions.

With explicit interest and unbundling of service charges, however, consumers would become more receptive of a technology that directly reduces their transaction costs. Cost considerations now work against the widespread application of EFT to consumer accounts, but eventually, electronic payments appear destined to replace paper checks. Regulations that permit a more explicit and efficient pricing structure should help stimulate cost-saving technological innovations such as EFT. The introduction of NOW accounts might help to promote such a price structure, despite the deterrent effect of the tax considerations noted above.

Right direction?

Payment of explicit interest on checking accounts is a major step in unbundling bank service charges and in promoting an explicit and efficient pricing structure. Such a price structure would provide a valuable framework for the spread of EFT into the consumer market—an innovation that would ultimately improve the lot of consumers and society. In addition, NOW accounts could be a step toward the removal of Regulation Q ceilings on deposits. With Reg Q rate ceilings removed, consumers could have a better chance of earning open-market rates of interest, which they cannot easily do now except when they hold large portfolios. In the meantime, money-market funds (taxable and tax-exempt) are increasing their competition for consumer transactions and savings balances. In such a world, the expansion of NOW accounts and the relaxation of Reg Q ceilings may provide the strongest possible defense for financial institutions. The recent Administration proposal, if enacted, will certainly not be the end of financial regulatory reform, but it will be a step in that direction.

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BANKING DATA—TWELFTH FEDERAL RESERVE DISTRICT

(Dollar amounts in millions)

Selected Assets and Liabilities Large Commercial Banks	Amount Outstanding 8/10/77	Change from 8/3/77	Change from year ago Dollar	Change from year ago Percent
Loans (gross, adjusted) and investments*	101,140	+ 1,897	+ 11,881	+ 13.31
Loans (gross, adjusted)—total	78,068	+ 1,527	+ 10,566	+ 15.65
Security loans	2,919	+ 1,051	+ 787	+ 36.91
Commercial and industrial	23,523	– 149	+ 2,024	+ 9.41
Real estate	24,886	+ 157	+ 4,394	+ 21.44
Consumer instalment	13,355	+ 65	+ 1,940	+ 17.00
U.S. Treasury securities	8,839	– 26	– 660	– 6.95
Other securities	14,233	+ 396	+ 1,975	+ 16.11
Deposits (less cash items)—total*	97,705	– 78	+ 8,817	+ 9.92
Demand deposits (adjusted)	28,156	+ 479	+ 2,611	+ 10.22
U.S. Government deposits	338	– 146	+ 13	+ 4.00
Time deposits—total*	67,455	– 174	+ 5,909	+ 9.60
States and political subdivisions	5,276	– 139	– 514	– 8.88
Savings deposits	31,858	– 68	+ 5,136	+ 19.22
Other time deposits‡	28,359	+ 49	+ 1,675	+ 6.28
Large negotiable CD's	10,800	+ 65	– 283	– 2.55

Weekly Averages of Daily Figures	Week ended 8/10/77	Week ended 8/3/77	Comparable year-ago period
Member Bank Reserve Position			
Excess Reserves (+)/Deficiency (–)	+ 30	+ 99	+ 19
Borrowings	172	15	2
Net free(+)/Net borrowed (–)	– 142	+ 84	+ 17
Federal Funds—Seven Large Banks			
Interbank Federal fund transactions			
Net purchases (+)/Net sales (–)	+ 526	– 195	+ 204
Transactions with U.S. security dealers			
Net loans (+)/Net borrowings (–)	+ 400	+ 196	+ 444

*Includes items not shown separately. ‡Individuals, partnerships and corporations.

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