Research Department
Federal Reserve
Bank of
San Francisco

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FRBSF Weekly Letter

Membership I—The Background

Over the past decade, the Federal Reserve System has experienced an accelerating withdrawal of member banks and a consequent decline in the amount of banking-system deposits subject to Federal Reserve requirements. To help stop this attrition, the Board of Governors this month released proposals to reduce the burden on Federal Reserve member banks and simultaneously move toward competitive equality among financial institutions generally. In this first of two articles, we discuss the background to the problem and outline the Fed's proposed solution. Next week, we will describe the Fed's proposals in greater detail.

Membership decline
A total of 551 banks have withdrawn from the Federal Reserve System over the past decade, and the majority of newly-formed banks have chosen to remain outside the System. As a result, the proportion of commercial-bank deposits held by member banks has declined sharply, from 83 percent in 1965 to about 73 percent today. In earlier years, most banks that withdrew were smaller banks, for whom the System provided less attractive services than those available through correspondent banks. More recently, however, the withdrawals have included an increasing number of larger banks. In 1977, for example, 15 of the 69 banks that left the System had deposits of over $100 million.

The end result could be a strikingly different Federal Reserve System, composed primarily of large banks and lacking direct ties to the rest of the banking system. Such a development would eliminate the Fed's unique character as a decentralized central bank serving institutions of many sizes all over the nation. In the Board's words, the erosion of membership and of member-bank deposits "threatens to weaken the nation's financial system as more and more of the nation's payments and credit transactions are handled outside the safe channels of the Federal Reserve, as fewer and fewer banks have immediate access to the Federal Reserve Bank credit facilities, as a national presence in bank supervisory and regulatory functions becomes increasingly diluted, and as implementation of monetary policy becomes more difficult."

Rising rates, dual system
The decline in membership can be traced to the rising trend of market interest rates, which has increased the implicit cost of assets frozen in the non-earning reserves required of member banks. Many banks have concluded that the benefits of Federal Reserve membership do not offset the cost of System reserve require-

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ments. In the U.S., the dual-banking system of national and state chartering gives banks the option of withdrawing from membership and choosing non-member status, because state-chartered banks need not become System members.

State non-member banks are subject to state reserve requirements, which vary from state to state but are usually effectively lower than System requirements, whatever the formal level of reserve ratios. This is so because many states allow U.S. government securities to serve as reserves, which pay interest directly. Again, most states permit reserve assets to be held as balances at (correspondent) banks, which earn an indirect return in the form of various banking services provided by the correspondents. Thus, non-member banks gain access to the national payments mechanism through member correspondent banks, and pay a lower net cost in the process.

In contrast, member-bank reserves are limited to cash and deposits at Federal Reserve Banks. These assets bear no interest, and their indirect value depends on what each bank receives in the form of Federal Reserve services—check clearing, funds transfer, provision of coin and currency, securities safekeeping, access to credit, and so on. Up until about the 1950's, the value of these services more than matched alternative market yields, but the picture has changed considerably with the inflation-caused upsurge in market rates of the past decade or so. Instead of market yields of 1-to-2 percent, banks are now able to earn rates of 5-to-7 percent on their earning reserves, so that a net benefit from System membership has turned to a net burden for many banks. According to some estimates, the aggregate burden could exceed $650 million.

The problem of membership, moreover, involves not only non-member commercial banks but also a wider group of non-bank financial institutions. Savings-and-loan associations, mutual savings banks and credit unions boast even lower reserve requirements than non-member banks, and are beginning to take on many of the characteristics of commercial banks. In the Northeast, many of these thrift institutions have begun to offer NOW accounts, which are deposits combining the interest-bearing features of savings accounts and the third-party transactions features previously limited to commercial-bank demand deposits. NOW accounts as such are still limited to that one part of the country, but transactions-type accounts have been appearing elsewhere, in the form of S&L remote-payments terminals and credit-union share drafts.

Proposed solution

Under existing arrangements, Federal Reserve member banks bear a "tax" in the form of non-interest-bearing reserves—a tax which is not paid by non-member banks and which frequently is not offset by the value of System services a bank receives. The Fed's ability to act on its own to reduce this burden is limited. The ability to reduce reserve requirements is limited by statute and by monetary-policy considerations.

The Fed's proposals thus include two major packages. The first package is embodied in proposed legislation, submitted to Congress in the form of the Reserve Requirements Act of 1978. This legislation would require all institutions offering transactions-type deposits to maintain appropriate reserves with the Federal Reserve System, but would grant them access to certain Fed services as compensation.

The second package involves Federal Reserve actions to lower reserve requirements on demand deposits, impose fees on certain services and broaden access to those services, and pay interest on reserve balances. In conjunction with this package, the Board submitted to Congress the Interest on Reserves Act of 1978. As introduced, this bill would establish a ceiling on the payment of interest on reserve balances.

The Fed's proposals are directed not only at arresting the decline in membership but also at restoring competitive equality with non-member banks as well as other institutions now providing transactions-type accounts. The introduction of service charges can be seen as a means of encouraging more efficiencies in the functioning of the nation's financial sector.

The Federal Reserve can act under existing authority to lower reserve requirements on member-bank demand deposits, but it needs Congressional approval for imposing uniform reserve requirements on all transactions deposits. The Fed does not contemplate introducing pricing of services unless interest is paid on reserves, so several parts of the package depend on Congressional action. Hearings are scheduled for late this month, but it is difficult to predict when final legislative action will occur. Nonetheless, the Fed's action shows its intention to reduce the burden borne by member banks and thereby slow the exodus from the System.

Robert Johnston

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BANKING DATA—TWELFTH FEDERAL RESERVE DISTRICT
(Dollar amounts in millions)

Selected Assets and Liabilities Large Commercial Banks	Amount Outstanding 7/5/78	Change from 6/28/78	Change from year ago Dollars	Change from year ago Percent
Loans (gross, adjusted) and investments*	114,566	+ 1,091	+ 15,557	+ 15.71
Loans (gross, adjusted)—total	92,630	+ 1,615	+ 16,434	+ 21.57
Security loans	3,043	+ 1,052	+ 572	+ 23.15
Commercial and industrial	27,859	− 84	+ 4,097	+ 17.24
Real estate	30,893	+ 156	+ 6,457	+ 26.42
Consumer instalment	16,379	+ 122	+ 3,576	+ 27.93
U.S. Treasury securities	8,149	− 371	− 989	− 10.82
Other securities	13,787	− 153	+ 112	+ 0.82
Deposits (less cash items)—total*	112,427	+ 1,644	+ 14,173	+ 14.42
Demand deposits (adjusted)	31,248	+ 1,419	+ 2,972	+ 10.51
U.S. Government deposits	464	− 116	− 62	− 11.79
Time deposits—total*	78,283	− 95	+ 11,129	+ 16.57
States and political subdivisions	6,565	− 102	+ 853	+ 14.93
Savings deposits	31,778	+ 123	− 169	− 0.53
Other time deposits‡	36,711	− 45	+ 9,381	+ 34.32
Large negotiable CD's	18,309	+ 3	+ 7,923	+ 76.29

Weekly Averages of Daily Figures	Week ended 7/5/78	Week ended 6/28/78	Comparable year-ago period
Member Bank Reserve Position			
Excess Reserves(+)/Deficiency (−)	+ 82	+ 15	+ 33
Borrowings	44	74	1
Net free(+)/Net borrowed (−)	+ 38	− 59	+ 32
Federal Funds—Seven Large Banks			
Interbank Federal fund transactions			
Net purchases (+)/Net sales(−)	− 1,608	− 860	− 725
Transactions with U.S. security dealers			
Net loans (+)/Net borrowings (−)	324	+ 440	+ 19

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

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