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BANKING: THE WINDS OF CHANGE

REMARKS OF

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Mr. Balles reviews new legislative proposals that would permit depository institutions to pay interest on consumer checking-type accounts and to receive interest on their required reserve balances. He states that there are three "imperatives" associated with the new bill. First, it should begin to equalize the ground rules among competing classes of institutions, so that all participants in the new system would be subject to the same restrictions on interest rates payable and on required reserves. Second, it should minimize the burden of Federal Reserve membership, by permitting payment of at least some interest on reserves held as deposits with the Fed. Third, it should restore to the Fed some of the control that it has lost over the volume of money, and thus improve its management of monetary policy.

We in the Federal Reserve have done our best to contribute to the theme of this year's convention (Create a Wave). In fact, we have created lots of waves with our support of the Administration's recent legislative proposals, which would permit depository institutions to receive interest on their required reserve balances and to pay interest on consumers' checking-type accounts. (These are known as NOW accounts—i.e., negotiable orders of withdrawal.) Yet many people, in Congress and in the banking community, tend to think that the Fed and the Treasury alone are responsible for all these waves, when in actuality the basic driving force is the winds of change that have been sweeping through the marketplace for the last several decades. Thus, I think it would help if we first looked at these underlying factors before examining the legislative proposals that will be discussed in next week's Senate hearings.

I realize that I might be at a slight disadvantage in presenting the Fed or the Treasury position here. As a wise philosopher once said, the three most suspicious-sounding phrases in the English language are 1) the check is in the mail; 2) certainly I'll respect you just as much in the morning; and 3) I'm from the Government and I'm here to help you. But bear with me, and I'll try to outline the logic of the Federal Reserve's position as it meshes with the current realities of the nation's financial system.

Background to Reform

Three inter-related developments over the years have created the environment for the current legislative proposals. First, there has been the major drive by thrift institutions for expanded powers rivalling those of commercial banks. These would include

loan and investment powers, and most importantly, those related to third-party payments or bill-paying services—for example, NOW accounts for New England mutual-savings banks and savings-and-loan associations, demand deposits for certain mutual-savings banks, and share drafts of credit unions. Thus, savings accounts at thrifts have begun to behave more like demand deposits—that is, more like a medium of exchange.

Historically, the unique distinction between commercial banks and other financial institutions has been the banks' right to accept demand deposits and to operate the nation's payments mechanism. But their role by now has been seriously weakened—and thrift institutions can be expected to expand their third-party payments activities whether or not the banks get NOW accounts. Indeed, those banks which don't join the NOW parade may be in serious danger of losing their share of the market.

A second crucial development has been the long-standing inequity between member and non-member banks concerning the burden of reserve requirements. Yet, ironically, there are now new inequities to contend with—between commercial banks as a whole and thrift institutions, and even between S&L's and credit unions, the latter having the least burdensome requirements.

A third major development has been the continued erosion of Federal Reserve membership, to the point where 25 percent of all demand deposits are now held by non-member banks. As thrift institutions get money-like liabilities, this erosion will spread even further. It must be emphasized that this development prevents the Fed from being fully able to control the volume

and rate of growth of money—that is, to use monetary policy as a means of promoting economic stability.

As a result, I see three imperatives in the new bill. First, it should begin to equalize the ground rules among competing classes of institutions, so that all participants in a nationwide NOW system observe the same restrictions on interest rates payable and on required reserves. Second, it should minimize the burden of Federal Reserve membership, by permitting payment of at least some interest on reserves held as deposits at the Fed. Third, it should restore to the Fed some of its lost control over the volume of money, and thus improve its management of monetary policy.

Background to NOWs

Against this background, let's consider the evolution of the NOW-account proposal. Over the past several decades, businesses and consumers have both found ways of improving the rates of return on their funds, especially by economizing on the use of non-interest bearing checking accounts. Banks have responded by moves to improve their own rates of return, in some cases by dropping membership in the Federal Reserve System and using the reserves released thereby for money-making purposes. In the process, of course, they have lost certain Federal Reserve services that are also frequently priced below market.

The situation logically would seem to demand a move towards "unbundling," with each bank charge and each bank service being priced explicitly at the market. The securities industry has been going through just such a process during the past year or so, under pressure from the Securities and Exchange Commission. But many banks and

thrift institutions, seeing only one side of the equation, fear unbundling for the impact it could have on their earnings.

A recent Federal Reserve staff study considered this problem in detail, specifically in regard to the proposed lifting of the Depression-era prohibition against payment of interest on demand deposits. The study argued that if banks began to pay explicit interest on demand deposits, they undoubtedly would also move to price checking and other services more nearly in line with costs. On the plus side, this would tend to curtail uneconomic use of certain bank services and would encourage an allocation of resources to uses more highly valued by the public. However, the payment of explicit interest on all demand deposits would mean temporarily reduced bank earnings—perhaps by as much as 5 to 20 percent of pre-tax earnings during the worst year of the transition.

The largest transitional impact would be felt if interest were paid on all demand deposits and if thrift institutions were also empowered to offer such deposits. But the impact could be limited if interest payments were paid only on consumers' NOW-type accounts instead of on all demand deposits. Nationwide, the volume of demand deposits that could be converted to NOWs probably amounts to about \$80 billion, as opposed to the roughly \$320 billion found in all checking accounts. As the Fed study noted, the earnings impact could be further limited by controlling the interest rate paid on NOWs and by phasing in the change over a several-year period. Moreover, cost pressures resulting from deposit interest payments could be partially offset by the payment of interest on required reserve balances held at Federal Reserve Banks.

Background to Membership Issue

This brings up the question of Federal Reserve membership—an issue of crucial importance to the central bank and to the nation's entire financial system. We start with the System's basic belief that the broadest possible membership is essential for the proper control of the reserve base and thereby for the proper conduct of monetary policy. "Reserve requirements are the fulcrum against which we work," as one of my colleagues neatly puts it.

I'm sure that you can all understand our position, but as many of you tell us, your own earnings statements frequently dictate a choice against membership. The costs of membership are primarily reflected in required reserves, which impound at the Fed some funds that banks feel they could employ better elsewhere. In fact, about two-thirds of a group of 250 banks which withdrew during the 1965-74 period cited reserve requirements as the reason. I don't want to overstate the problem. Some portion of the vault cash maintained for operational purposes, and some of the reserve accounts held at Reserve Banks and used for clearing balances, clearly do not represent foregone earnings. Also, the Federal Reserve incurs expenses of about \$350 million per year for providing coin, currency, checking and other services to member banks. Still, as Chairman Burns said in recent Congressional testimony, withdrawals reflect mainly the "high cost of non-interest earning reserves that banks are required to hold as members of the Federal Reserve."

Everyone would probably agree that the existence of a well-functioning central bank brings broad benefits to the banking community, and that it would be equitable to expect banks to bear some of the burden of policy, provided that the costs are fairly

shared. But that is the crux of the problem; the burden of reserve requirements is borne unevenly between members and non-members. For example, 22 states—unlike the Fed—permit commercial banks to hold securities as a portion of their reserves. Thus, if only quantifiable costs and directly provided clearing services are taken into account, the vast majority of banks would find it less costly to meet state-imposed reserve requirements than to meet Federal Reserve requirements. That situation of course is not new; however, in the recent environment of inflation and high interest rates, member banks forego more earnings than formerly by maintaining reserves at the Fed instead of employing them in loans or securities.

Proposed Legislation

All of these factors and more have helped to mold Federal Reserve thinking on the solutions to banking's structural problems. The Fed's views are reflected in the Administration bill which the Senate Banking Committee plans to take up next week. As you can see, it is a far-reaching package that will affect the interests of all the participants in the nation's financial markets.

First of all, the draft bill authorizes NOW accounts for all insured commercial banks, mutual savings banks, savings and loan institutions, and credit unions. (The latter could issue both NOWs and share-draft accounts, or SDAs.) These interest-bearing checking accounts would be limited to the use of individuals. The ceiling rate payable on NOWs or SDAs would be set—for a three-year period, followed by three years of standby authority—by an inter-agency committee at a uniform figure below the bank savings-deposit ceiling rate, currently 5 percent. Those New England institutions which are now offering a higher rate than

the new ceiling rate could continue to do so for a three-year period. Also, authority for Regulation Q interest-rate ceilings, including the ¼-percent differential for thrift institutions, would be continued through 1979. The agency committee would be chaired by the Federal Reserve Board Chairman, and would also include the FDIC Chairman, the Home Loan Bank Board Chairman, and the National Credit Union Administrator.

In another major innovation, the legislation would impose uniform reserve requirements on NOWs and SDAs for all depository institutions. The Federal Reserve Board of Governors would set these requirements, within specified limits ranging from 3 to 12 percent of deposits. (Fed member banks' reserve requirements would continue to range between 3 and 10 percent for other time and savings deposits, and also between 7 and 22 percent for demand deposits, but with a 5-percent minimum for banks with less than \$15 million in net demand deposits.) The reserve requirements against NOWs and SDAs would be phased in over a three-year period for those institutions offering such instruments which do not now belong to the Fed. In addition to vault cash, the reserves could be held in the form of deposits directly with the Federal Reserve, or indirectly with other regulatory institutions for redeposit with the Fed.

The other major feature of the bill involves the authorization of payment of interest on reserve balances with the Fed (not including vault cash), at rates determined by the Fed's Board of Governors. However, the aggregate interest paid in any year could not exceed 10 percent of Reserve Banks' net earnings for the previous year, before

payment of interest on reserve balances. In setting this interest rate, the Fed would be expected to consider the possible effects on Treasury revenues and on banks' revenues—as well as the effect on the Federal Reserve membership problem.

In this regard, it should be noted that at the present level of earnings, the indicated maximum could not exceed \$600 million a year—roughly equal to 2¼ percent of required reserve balances. Given all the uncertainties in this area, it is doubtful that that 10-percent ceiling would prove adequate for coping with the cost problems of member banks. Indeed, simply overcoming the costs associated with the burden of membership could cost \$500 million a year, so that there would be little room left for alleviating the transition costs of NOWs or for meeting other possible changes, such as explicit charges for Fed services. For that reason, there is a good argument for setting the maximum payment to depository institutions at 15 percent instead of 10 percent of Reserve Bank earnings.

Meanwhile, we should remember that the bill offers a potential for reduced bank costs through a lower statutory minimum for reserve requirements on demand deposits. Large reductions should not be attempted overnight, but there would be some leeway for reductions over time within the proposed range of requirements. Although not in the proposed bill, I believe that a case could also be made to reduce the statutory minimum on time-and-savings deposits from 3 to 1 percent.

Concluding Remarks

From what I've said, you can see that the new legislation is both far-ranging and complex, affecting the interests of business

people, consumers, regulators, banks, thrift institutions and ordinary taxpayers. However, I should emphasize that a great deal of thought has gone into the development of the Federal Reserve's and the Administration's position on the issues now facing the financial community. I've already summarized the main features of the Federal Reserve staff study. In addition, our Reserve Bank directors last month conducted an opinion survey of District member banks, as a means of informing the Board of Governors as well as themselves of how bankers feel about all these issues. Those of you who participated in the survey helped us a great deal in formulating our own thoughts.

Admittedly, there were few surprises in the survey responses. Member banks, both here in Oregon and throughout our nine-state district, strongly favored the payment of interest on required reserves. (Incidentally, they also favored an alternative proposal—counting interest-earning assets as part of required reserves.) But not surprisingly, member banks generally opposed paying interest on demand deposits, or even the widespread adoption of NOW accounts—although a majority of the large banks in the survey differed with the consensus and favored NOW accounts. In fact, banks holding more than three-fifths of all member-bank deposits in the District favored both nationwide NOWs and the payment of interest on demand deposits. The survey respondents also reported a broad level of satisfaction with Reserve Bank services—such as check collection, wire transfer, and coin and currency services—and generally expressed willingness to pay for such services if the Federal Reserve were to pay interest on their reserve balances.

Bankers' opinions, as expressed through our survey or through other means, are necessary grist for the legislative mills. The other interests that I've listed also will have their say before legislation advances very far. But I believe that the Administration's legislative package will provide a logical and comprehensive solution to the problems I have discussed today. After you read and ponder those proposals, I hope that you will give them your support.

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