THE FEDERAL RESERVE MEMBERSHIP PROBLEM

Address by
Lawrence K. Roos
President
Federal Reserve Bank of St. Louis

Before the
ARKANSAS BANKERS ASSOCIATION CONVENTION
Hot Springs, Arkansas
May 16, 1977

Coming to Hot Springs is always a pleasure. This is one of America's most beautiful resort cities and, certainly, one of the most beautiful parts of the Eighth Federal Reserve District.

For me, personally, being here today is a special pleasure because this occasion offers an opportunity to meet and talk with so many of our good friends in the banking industry.

As a representative of the Federal Reserve System, I wanted to be particularly careful to choose a subject that would be of interest to each of you, whether your bank happens to be a member of the Fed or whether it is a non-member. After giving the matter some thought, it occurred to me that one current topic that should be of interest to all bankers is the subject of Fed membership, sometimes referred to as the Federal Reserve membership problem.

From the perspective of you who are associated with member banks, the importance of finding an early solution to the membership problem is obvious. Membership is an issue that affects member banks' earnings and, after all, for most of you the "bottom line" is of more than passing importance. I'm sure that more than a few of you Fed members and your boards of directors are currently struggling with the question of whether your bank's best interests are best served by continuing your membership in the Federal Reserve System.

Indeed, this is not a decision to be taken lightly. For most member banks, to leave the System would mean departing from a relationship of long standing, a tradition that, perhaps, dates from the bank's founding. More important, leaving the System would mean giving up access to the discount window, losing the benefits of seasonal borrowings and giving up many other services provided by the Federal Reserve which are of value to you.

For non-member banks, the membership question should be of importance also because the ultimate resolution of the problem, whatever it may be, is certain to have a major impact on the future of our overall financial system, and the prosperity of all banks is dependent upon the perpetuation of a strong national economy.

Members and non-members alike share an interest in the continued ability of the Federal Reserve System to conduct monetary policy in an independent manner geared to the best interests of a free economy. Should membership in the System continue to erode, the capacity of the Federal Reserve to retain the independence necessary to perform its functions would almost certainly be lessened.

Just how severe has the decline in Federal Reserve membership been? In 1945, almost half the banks in the country were members of the Federal Reserve System. At the end of last year, only 39% of the country's banks were members. In 1945, member banks held 86% of all domestic deposits. At the end of last year they held only 74%.

Furthermore, the rate of decline has accelerated in the past few years. Since 1973, banks have been withdrawing from the System at a rate of almost one a week. All of which underscores the severity of the problem and the urgency of finding an early solution.

What has caused member banks to withdraw from the System? It is obvious that the principal factor is the relative cost of membership as compared with non-membership. That cost, simply stated, is the cost of maintaining non-earning assets as required by the Federal Reserve. Although non-members must maintain some manner of reserves for purposes of liquidity, they can frequently do so at a lesser cost than incurred with Fed membership. The problem is very much a pocketbook issue. As such, any solution, to be meaningful, must be designed to reduce the cost differential that has caused the problem.

A number of solutions have been suggested.

One approach would be to eliminate the differential between the costs of membership and non-membership by requiring all financial institutions that directly or indirectly use Federal Reserve services to hold reserves with the Fed.

Another suggested solution would be for the Federal Reserve to expand services to give member banks more for their money.

A third possibility would be to lower member bank reserve requirements.

Still, another solution would be to lower the cost of membership by allowing members to earn a return on their required reserves.

The first of these approaches, that is, to require all banks to maintain reserves with the Fed, has been suggested in the past. In fact, in 1974, the Board of Governors of the Federal Reserve System sent to Congress draft legislation to apply reserve requirements set by the Federal Reserve to demand deposits and negotiable orders of withdrawal at all financial institutions.

That bill never got out of committee.

The extension of reserve requirements to all financial institutions would almost certainly face widespread opposition. Financial institutions not presently subject to Fed reserve requirements would almost certainly oppose the proposal. Such opposition has been successful in blocking legislative authorization for universal reserve requirements in the past; there is little reason to believe that such proposals would fare better today.

The second possible approach I mentioned is for the Fed to offer member banks more in terms of expanded services.

A study by our research staff at the Federal Reserve Bank of St. Louis indicates that smaller member banks which maintain reserves at the Fed use the services of correspondent banks almost as extensively as smaller non-member banks. This means that many Fed members do not take advantage of the full scope of services offered by the Fed. And, of course, certain services available at larger correspondent banks are not offered by the Federal Reserve. It is conceivable that something could be done to encourage smaller member banks to use Federal Reserve services more extensively in order to receive more for the cost of membership. However, our research staff has concluded that without completely changing the nature of the central bank and without seriously altering the established pattern of correspondent bank relationships, the Fed cannot expand its services enough nor attract enough additional use of its services to make any significant change in the current balance between membership costs and benefits.

The alternative of lowering reserve requirements is an interesting one. It would enable member banks to gain maximum flexibility in converting reserves into earning assets. It would be among the least expensive options available to the Federal Reserve in that Fed earnings would drop only to the extent that the Open Market sold securities to offset the reductions in reserve requirements.

This proposed solution, however, has several significant disadvantages. It could create serious problems for monetary policy and could not be fully implemented without enabling legislation. More importantly, it would provide little relief for smaller banks for which reserve requirements are presently at or near the statutory minimums. Moreover, if the Fed were to rely on this avenue for solving the membership problem, it could be difficult to raise reserve requirements should future economic and financial conditions warrant. For these reasons, this alternative probably should not be given serious consideration.

Which leaves us with the fourth possible approach to the problem: authorizing earnings on required reserves.

Several methods for accomplishing this have been suggested. Some students of the membership problem have proposed authorizing the Fed to pay direct interest on required reserves. Others have proposed granting members permission to hold their reserves, or some part of their reserves, in interest-bearing government securities. Still others have suggested various schemes for granting members borrowing privileges at artifically low interest rates, thus providing them with an opportunity for earnings through reinvestment of such borrowings.

All of these proposals have one thing in common; they would have the effect of increasing income to member banks. This, unfortunately, raises political as well as economic problems.

Payment of interest on member bank reserves would require legislation by Congress in the form of an amendment to the Federal Reserve Act. Political opposition to any such proposal could be expected from a variety of sources for a variety of reasons.

Correspondent banks, for instance, might view payment of interest on reserves as an inducement for small banks to seek Fed membership, thereby reducing their demand for correspondent services. Actually there are few grounds for such concern on the part of large correspondent banks for, as I mentioned a moment ago, studies show that smaller member banks presently use the services of commercial correspondents to almost the same extent as small non-member banks. So, even if payment of interest on required reserves were to attract more small non-member banks into the Federal Reserve System, correspondent banks probably would not find the market for their services much reduced.

Further opposition to interest on reserves could be expected from non-member banks which would probably view such action as a loss of the competitive advantage they now enjoy.

But the primary cause for opposition would undoubtedly arise from the fact that payment of interest on reserves would have the effect of reducing the amount of funds presently being returned by the Federal Reserve System to the U. S. Treasury.

In 1976, member bank reserves averaged about $34 billion. At an interest rate of 4.5%, interest on those reserves, if it had been paid, would have amounted to approximately $1.5 billion. Thus, Federal Reserve earnings, which presently amount to upwards of $6 billion annually, would have been reduced by $1.5 billion. And, since the Federal Reserve transfers all its "profits" to the Treasury, Treasury revenues from the Fed could be expected to decrease with payment of interest on reserves.

Of course, Treasury revenues wouldn't decrease by the full $1.5 billion because member banks would return a portion of that sum to the Treasury in the form of taxes. But, still, they would be reduced substantially.

The fact that funds currently going to the Treasury would increase earnings of commercial banks would almost certainly spark opposition from some members of Congress and certain segments of the general public who are frequently suspicious of anything which increases bank profits. And the effect of opposition from these sources cannot be minimized.

Thus, any solution to the membership problem involves immense inherent complications. And, lest you have not already become totally discouraged,let me point out still further factors complicating the solution of the membership problem.

As you know, thrift institutions in several northeastern states have been authorized to offer their customers interest-bearing accounts that do not substantially differ from checking accounts. Negotiable orders of withdrawal, or NOW accounts, as they are commonly called, seem destined to spread nationwide.

The extension of NOW accounts could further exacerbate the membership question, for member banks, when subjected to the increased cost of paying interest on NOW accounts, would be even more resistant to bearing the cost of Fed membership. It can safely be assumed that, unless a way is found to reduce the cost of Fed membership prior to, or simultaneous with the extension of NOW account authority, the erosion of Fed membership will continue at an accelerated pace.

Which brings us to still another complication: the issue of access to Fed services by non-member financial institutions.

While thrift institutions are threatening to compete nationwide with commercial banks for checking account business, thrifts and other non-members are also pushing for access to Federal Reserve services without having to bear the costs of membership. Concurrently, the Department of

Justice is pressing the Federal Reserve System to provide its clearing and transfer services without discrimination on the basis of membership, and to price these services in such a way as to permit competition from private firms that may want to offer similar services. Obviously, if present membership requirements remain unchanged, and if all financial institutions, member or non-member alike, have access to Fed facilities and services without being subjected to reserve requirements, the incentive for maintaining membership would be all but eliminated.

All of these issues have a bearing on proposals for solutions. All are obstacles to an easy solution. The membership problem, which in itself is complicated, becomes part of an extremely complex set of related issues, each of which affects many groups in many ways.

The Board of Governors and the Reserve Banks have been working diligently to devise legislation to ease the membership problem. Hopefully, draft legislation will be forthcoming for consideration by Congress before too long. But any draft legislation is only a first step toward solving the membership problem. Any such proposals will be subjected to the legislative process, and along the way the many diverse interests involved--large banks, small banks, correspondent banks, member banks, non-member banks, thrift institutions, and public interest groups--almost certainly will want to be heard from.

Each of these groups has special interests. Each can be counted on to express their own points of view vociferously. A consensus may not come easily.

Yet, a solution must be found. The Federal Reserve System must maintain the strength necessary to defend its ability to effectively perform its functions. If the Federal Reserve, through erosion of its membership base, were to be weakened so as to lose its ever present traditional independence, we, as a nation, will be unable to maintain the economic strength which has provided the bulwark for our growth and prosperity. If that were to happen, every financial institution and, in fact, every individual citizen of the United States would suffer the terrible consequences, just as the people of Great Britain today endure the harsh economic conditions that have stemmed to a large extent from the loss of independence of the Bank of England.

So, I say, we must solve the Federal Reserve membership problem and I have absolutely no doubt that we will. But to do so will require a spirit of "give and take" and a willingness of all parties concerned to compromise a portion of their own interests for the good of all.

The American free enterprise has elevated us from a weak nation at the time of the Revolution into the greatest agricultural and industrial power on earth. So successful is our system that we define poverty at an income level higher than the average income level of the world's second most powerful nation, the Soviet Union.

I believe that we can maintain the economic progress we have made and build upon it. A strong Federal Reserve System is an essential element in accomplishing that objective. For the Fed to function with optimum effectiveness, it must have a constituency of member banks which support the objective of the System and which are not penalized by reason of their membership in the System.

This is a critical time for you as commercial bankers and for us as representatives of our central banking system. Important decisions will be made that are certain to have an impact on our nation's economy long into the future. Whether we are able to reconcile our differences and work together to resolve them in the interest of a stronger and a greater America will determine the course and quality, not only of our lives, but of the lives of future generations for years to come.