MONETARY CONTROL AND THE MEMBERSHIP PROBLEM

HEARINGS

BEFORE THE

COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS HOUSE OF REPRESENTATIVES

NINETY-FIFTH CONGRESS

SECOND SESSION

ON

H.R. 13476

A BILL TO AMEND THE FEDERAL RESERVE ACT TO PROVIDE FOR THE MAINTENANCE OF RESERVES FOR CERTAIN INSTITUTIONS

H.R. 13477

A BILL TO AMEND THE FEDERAL RESERVE ACT TO AUTHORIZE THE PAYMENT OF INTEREST ON RESERVE BALANCES

H.R. 12706

A BILL TO AMEND THE FEDERAL RESERVE ACT TO PROVIDE FOR THE PRICING OF FEDERAL RESERVE SYSTEM SERVICES AND THE PAYMENT OF INTEREST ON RESERVES

H.R. 14072

A BILL TO FACILITATE THE IMPLEMENTATION OF MONETARY POLICY AND TO PROMOTE COMPETITIVE EQUALITY AMONG COMMERCIAL BANKS

JULY 27, 31; AUGUST 4, 11; AND SEPTEMBER 22, 1978

Printed for the use of the
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MONETARY CONTROL AND THE MEMBERSHIP PROBLEM

THURSDAY, JULY 27, 1978

House of Representatives,
Committee on Banking, Finance and Urban Affairs,
Washington, D.C.

The committee met at 9 a.m., in room 2128, of the Rayburn House Office Building, Hon. Parren J. Mitchell, Hon. Fernand J. St Germain presiding.

Present: Representatives Reuss, Ashley, St Germain, Gonzalez, Minish, Hanley, Mitchell, Patterson, Blanchard, LaFalce, AuCoin, Derrick, Lundine, Pattison, Cavanaugh, Oakar, Mattox, Vento, Barnard, Stanton, Brown, Wylie, Hansen, Kelly, Grassley, Fenwick, Leach, Steers, Evans of Delaware, Caputo, Hollenbeck, and Green.

Mr. Mitchell. Good morning, ladies and gentlemen.

This morning the Committee on Banking, Finance and Urban Affairs begins hearings on legislation dealing with Federal Reserve member bank reserves, the payment of interest thereon, and corollary questions.

The legislation before us includes H.R. 12706, which was introduced by Mr. Stanton with cosponsors, in May; a proposed amendment to that bill; and two Federal Reserve proposals which the chairman of this committee, Mr. Reuss, introduced on request on July 14: H.R. 13476 and H.R. 13477.

[The texts of the referred to bills, H.R. 13476, H.R. 13477, and H.R. 12706, follow:]

95TH CONGRESS
2D SESSION

H. R. 13476

IN THE HOUSE OF REPRESENTATIVES

JULY 14, 1978

MR. REUSS (by request) introduced the following bill; which was referred to the Committee on Banking, Finance and Urban Affairs

A BILL

To amend the Federal Reserve Act to provide for the maintenance of reserves for certain institutions.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That this Act may be cited as the "Federal Reserve Requirements Act of 1978".

TITLE I—RESERVE REQUIREMENTS OF MEMBER BANKS AND OTHER DEPOSITORY INSTITUTIONS

SEC. 101. The first section of the Federal Reserve Act, as amended (12 U.S.C. 221), is amended by adding at the end thereof the following new paragraphs:

"The term 'depository institution' means—

I

"(1) any insured bank as defined in section 3 of the Federal Deposit Insurance Act;

"(2) any mutual savings bank as defined in section 3 of the Federal Deposit Insurance Act;

"(3) any savings bank as defined in section 3 of the Federal Deposit Insurance Act;

"(4) any insured credit union as defined in section 101 of the Federal Credit Union Act;

"(5) any member as defined in section 2 of the Federal Home Loan Bank Act.

"(6) any insured institution as defined in section 401 of the National Housing Act; and

"(7) for the purpose of section 13 and the fourteenth paragraph of section 16, any association or entity which is wholly owned by or which consists only of institutions referred to in clauses (1) through (6).

"The term 'transaction account' means a deposit or account on which the depositor or account holder is allowed to make withdrawals by negotiable or transferable instrument or other similar item for the purpose of making payments to third persons or others. Such term includes demand deposit, negotiable order of withdrawal, and share draft accounts.".

SEC. 102. Section 19 (a) of the Federal Reserve Act, as amended (12 U.S.C. 461), is amended by adding at the end thereof the following: "In order to prevent evasions of the reserve requirements imposed by this Act, after consultation with the Board of Directors of the Federal Deposit Insurance Corporation, the Federal Home Loan Bank Board, and the Administrator of the National Credit Union Administration, the Board of Governors of the Federal Reserve System is further authorized to determine, by regulation or order, that an account or deposit is a transaction account where such account or deposit may be used to provide funds directly or indirectly for the purpose of making payments or transfers to third persons or others.".

SEC. 103. The last sentence of subsection (b) of section 19 of the Federal Reserve Act, as amended (12 U.S.C. 461), is designated as paragraph (7) and that part of subsection (b) that precedes that sentence is amended to read as follows:

"(b) (1) Except as provided in paragraph (4), every depository institution as defined in section 1 of the Federal Reserve Act, as amended (12 U.S.C. 221), shall maintain reserves against its demand deposits at such average ratio of not less than 7 per centum nor more than 22 per centum, as shall be determined by the Board.

"(2) Except as provided in paragraph (4), every depository institution as defined in section 1 of the Federal Reserve Act, as amended (12 U.S.C. 221), shall maintain reserves which shall be at the same level for all depository institutions against all other transaction accounts at such average ratio of not less than 3 per centum nor more than 12 per centum, as shall be determined by the Board.

"(3) Every member bank shall maintain reserves against its time deposits and savings deposits (other than negotiable order of withdrawal accounts) as such average ratio of not less than one-half of 1 per centum nor more than 10 per centum, as shall be determined by the Board.

"(4) A total of $5,000,000 of transaction accounts of a depository institution shall not be subject to the reserve requirements of this section, subject to such rules and regulations as may be adopted by the Board. However, the Board may impose reserve requirements on such transaction accounts at such average ratio of up to 7 per centum if determined to be appropriate in light of general liquidity, considerations of monetary policy, or other relevant conditions prevailing in the banking system.

"(5) Every depository institution as defined in section 1 of the Federal Reserve Act (12 U.S.C. 221) shall make reports concerning its deposit liabilities and required reserves at such times and in such manner and form as the Board may require.

"(6) (a) For purposes of determining the reserve requirements of a depository institution established after June

30, 1978 which is an affiliate of a depository institution subject to the reserve requirements of this section, the transaction accounts of such newly established depository institutions shall be added to the total transaction accounts of such affiliated depository institution.

"(b) In addition to its authority under section 19 (a), the Board is authorized to determine, by regulation or order, the affiliated depository institution to whose transaction accounts the transaction accounts of a depository institution established after June 30, 1978, shall be added for purposes of this provision.".

SEC. 104. With respect to any depository institution that is not a member of the Federal Reserve System on June 30, 1978, the required reserves imposed pursuant to subsection (a) against its transaction accounts on the effective date of this Act shall be reduced by 75 per centum during the first year that begins after the effective date, 50 per centum during the second year, and 25 per centum during the third year.

SEC. 105. (a) Section 19 (c) of the Federal Reserve Act, as amended (12 U.S.C. 461), is amended to read as follows: "Reserves held by any depository institution to meet the requirements imposed pursuant to subsection (b) of this section shall be in the form of—

"(1) balances maintained for such purposes by such depository institution in the Federal Reserve bank of which it is a member or at which it maintains an account. However, the Board may, by regulation or order, permit depository institutions to maintain all or a portion of their required reserves against the transaction accounts in the form of vault cash: *Provided*, That such proportion shall be identical for all depository institutions; and

"(2) balances maintained by a nonmember depository institution in a member bank or in a Federal home loan bank maintains such funds in the form of balances in a Federal Reserve bank of which it is a member or at which it maintains an account. Balances received by a member bank from another depository institution that are used to satisfy the reserve requirements imposed on such depository institution by this section shall not be subject to the reserve requirements of this section imposed on such member bank and shall not be subject to assessment imposed on such member bank pursuant to section 7 of the Federal Deposit Insurance Act, as amended (12 U.S.C. 1817).".

TITLE II—CONFORMING AMENDMENTS AND EFFECTIVE DATE

SEC. 201. Section 5A of the Federal Home Loan Bank Act, as amended (12 U.S.C. 1425a), is amended by redesignating subsection (f) as subsection (g) and by inserting before such subsection, as redesignated, the following new subsection:

"(f) Every institution which is a member or is an insured institution as defined in section 401(a) of title IV of the National Housing Act (12 U.S.C. 1724(a)) shall maintain reserves against its transaction accounts as defined in section 1 of the Federal Reserve Act (12 U.S.C. 221) in accordance with the provisions of section 19 of the Federal Reserve Act (12 U.S.C. 461) in amounts not less than such percentages of its aggregate amounts of such deposits or accounts as may be prescribed under section 19(b) of the Federal Reserve Act (12 U.S.C. 461) by the Board of Governors of the Federal Reserve System.".

SEC. 202. Section 116 of the Federal Credit Union Act, as amended (12 U.S.C. 1762), is amended by adding at the end thereof the following new subsection:

"(c) Each insured credit union shall maintain reserves against its transaction accounts as defined in section 1 of the Federal Reserve Act (12 U.S.C. 221) in accordance with the provisions of section 19 of the Federal Reserve Act (12 U.S.C. 461) in amounts not less than such percentages of its aggregate amounts of such deposits or accounts as may be prescribed under section 19(b) of the Federal Reserve Act (12 U.S.C. 461) by the Board of Governors of the Federal Reserve System.".

SEC. 203. (a) The first paragraph of section 13 of the Federal Reserve Act (12 U.S.C. 342) is amended as follows:

(1) by inserting after the words "member banks" the words "or other depository institutions";

(2) by inserting after the words "payable upon presentation" the first and third times they appear, the words "or other items, including negotiable orders of withdrawal or share drafts";

(3) by inserting after the words "payable upon presentation within its district," the words "or other items, including negotiable orders of withdrawal or share drafts";

(4) by inserting after the words "nonmember bank or trust company," wherever they appear the words "or other depository institution";

(5) by striking the words "sufficient to offset the items in transit held for its account by the Federal Reserve bank" and inserting in lieu thereof the words "in such amount as the Board determines taking into account items in transit, services provided by the Federal Reserve bank, and other factors as the Board may deem appropriate";

(6) by inserting after the words "nonmember

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bank" after the second colon the words "or other depository institution".

(b) The thirteenth paragraph of section 16 of the Federal Reserve Act (12 U.S.C. 360) is amended as follows:

(1) by striking out the words "member banks" wherever they appear and inserting in lieu thereof "depository institutions";

(2) by striking out the words "member bank" wherever they appear and inserting in lieu thereof "depository institution";

(3) by inserting after "checks" wherever it appears the words "and other items, including negotiable orders of withdrawal and share drafts".

(c) The fourteenth paragraph of section 16 of the Federal Reserve Act (12 U.S.C. 248(o)) is amended by striking out "its member banks" and inserting in lieu thereof "depository institutions".

SEC. 204. The provisions of this Act shall become effective one year after the date of enactment.

95TH CONGRESS
2D SESSION

H. R. 13477

IN THE HOUSE OF REPRESENTATIVES

JULY 14, 1978

Mr. REUSS (by request) introduced the following bill; which was referred to the Committee on Banking, Finance and Urban Affairs

A BILL

To amend the Federal Reserve Act to authorize the payment of interest on reserve balances.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That this Act may be cited as the "Interest on Reserves Act of 1978."

SEC. 2. Section 13 of the Federal Reserve Act is amended by adding at the end thereof the following new paragraph:

"Subject to such limitations, restrictions, and regulations as the Board of Governors may prescribe, the Federal Reserve banks are hereby authorized to pay interest on balances held in any Federal Reserve bank pursuant to section

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19 (c) (1) of this Act. The total amount of such interest paid with respect to any year shall not exceed the sum of the following items computed with respect to the same year:

"(A) total receipts by Federal Reserve banks from the recipients of such interest for services rendered to such recipients by such banks, and

"(B) 7 per centum of the total net earnings of the Federal Reserve banks computed without regard to the payment of such interest.

The rate of interest paid under this section shall not exceed 2 per centum per annum with respect to required balances in excess of $25,000,000 held at Federal Reserve banks.".

95TH CONGRESS
2D SESSION

H. R. 12706

IN THE HOUSE OF REPRESENTATIVES

MAY 12, 1978

Mr. STANTON (for himself, Mr. ASHLEY, Mr. HANNAFORD, Mr. BARNARD, Mr. WATKINS, Mr. WYLIE, Mr. ROUSSELOT, Mr. MCKINNEY, Mr. HYDE, Mr. KELLY, Mr. STEERS, Mr. EVANS of Delaware, and Mr. GREEN) introduced the following bill; which was referred to the Committee on Banking, Finance and Urban Affairs

A BILL

To amend the Federal Reserve Act to provide for the pricing of Federal Reserve System services and the payment of interest on reserves.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That this Act may be cited as the "Federal Reserve Membership Act of 1978".

SEC. 2. PRICING OF SERVICES.—(a) The Federal Reserve Act is amended by inserting after section 11 (12 U.S.C. 248) the following new section:

"SEC. 11A. (a) Not later than July 1, 1979, the Board of Governors shall have prepared and shall publish for public comment a set of pricing principles in accordance with this section and a proposed schedule of fees for Federal Reserve System services; and not later than July 1, 1980, the Board shall put into effect a schedule of fees for such services which is based on those principles.

"(b) The Federal Reserve System services which shall be covered by the schedule of fees under subsection (a) are—

"(1) currency and coin services;

"(2) check collection services;

"(3) wire transfer services;

"(4) automated clearinghouse services;

"(5) net settlement services;

"(6) securities safekeeping services; and

"(7) any new payment services which the Federal Reserve System provides, including but not limited to payment services that effectuate the electronic transfer of funds.

"(c) The pricing principles referred to in subsection (a) and the schedule of fees prescribed pursuant to this section shall be based on the following general principles:

"(1) All services shall be priced explicitly.

"(2) Prices shall be established on the basis of all direct and indirect costs actually incurred in providing the services priced, including overhead, and an allocation of imputed costs that take into account the taxes that would have been paid and the return on capital that would have been provided had the payment services been furnished by a private business firm.

"(3) Services shall be made available to any depository institution at the same fee schedule applicable to member banks.".

SEC. 3. INTEREST ON RESERVES.—Section 19 of the Federal Reserve Act is amended by inserting after subsection (b) (3) (12 U.S.C. 461 (b)) the following:

"(4) The Board shall pay interest on those reserves required to be held pursuant to this subsection. The rate of interest shall be periodically determined by an affirmative vote of not less than four members of the Board. The rate of interest shall not exceed the average rate paid during the preceding calendar quarter on United States Treasury bills with maturities of three months.

"(5) Not later than July 1, 1981, the Board shall prepare a study to be transmitted to the House Committee on Banking, Finance and Urban Affairs and Senate Committee on Banking, Housing, and Urban Affairs on the feasibility and impact of permitting member banks to invest a percentage of their required reserves in United States Treasury securities. The study shall examine the impact of such an arrangement on—

"(1) monetary and financial conditions;

"(2) Treasury revenues;

"(3) safety and soundness of member banks;

"(4) impact of benefits and costs of membership in Federal Reserve System.

"(6) In its annual report to Congress the Board shall provide a full account of the changes in membership during the preceding year, the pricing structure for services in effect during the preceding year, and the interest rate structure on reserves in effect during the preceding year.".

SEC. 4. DEFINITIONS.—(a) The Federal Reserve Act is amended by adding at the end of section 1 (12 U.S.C. 221) the following new paragraph:

"The term 'depository institution' means—

"(1) any insured bank as defined in section 3 of the Federal Deposit Insurance Act;

"(2) any mutual savings bank as defined in section 3 of the Federal Deposit Insurance Act;

"(3) any savings bank as defined in section 3 of the Federal Deposit Insurance Act;

"(4) any insured credit union as defined in section 101 of the Federal Credit Union Act;

"(5) any member as defined in section 2 of the Federal Home Loan Bank Act;

"(6) any insured institution as defined in section 401 of the National Housing Act; and

"(7) any association or entity which is wholly owned by or which consists only of institutions referred to in clauses (1) through (6).".

(b) The first paragraph of section 13 of the Federal Reserve Act (12 U.S.C. 342) is amended—

(1) by inserting "or other depository institutions" after "member banks";

(2) by inserting "or other depository institution" after "nonmember bank or trust company" each place it appears;

(3) by inserting "and other factors as the Board may deem appropriate" after the words "held for its account by the Federal Reserve bank"; and

(4) by inserting "or other depository institution" after "nonmember bank" in the second proviso.

(c) The thirteenth paragraph of section 16 of the Federal Reserve Act (12 U.S.C. 360) is amended as follows:

(1) by striking out the words "member banks" wherever they appear and inserting in lieu thereof "depository institutions"; and

(2) by striking out the words "member bank" wherever they appear and inserting in lieu thereof "depository institution".

(d) The fourteenth paragraph of section 16 of the Federal Reserve Act (12 U.S.C. 248(o)) is amended by striking out "its member banks" and inserting in lieu thereof "depository institutions".

Mr. MITCHELL. At the same time, Chairman Reuss announced that Mr. St Germain and I—as chairmen of the two subcommittees of relevant jurisdiction—would serve as cochairmen pro tem for these hearings. I am pleased to cochair these hearings.

Our ultimate purpose is to produce legislation that effectively improves the Federal Reserve's monetary control and promotes equitable competition in our banking system, without unduly increasing the Federal budget deficit.

I am concerned—as I am sure all of us are—about the Federal Reserve's failure to hit its announced target for M_1 growth for more than a year now. But I am not convinced that either mandatory universal reserve requirements or the payment of interest on member bank reserves to retain and attract members is needed to improve the accuracy of monetary control.

I can't take seriously the argument that universal reserve requirements are needed. In regard to the need for membership, I cannot resist quoting from a July 1977 study prepared by Golembe Associates for the American Bankers' Association:

* * * In fact, careful studies indicate that precise control of the monetary aggregates is not harmed by "nonmembership."

The proposed amendment to H.R. 12706 provides an alternative. It would improve the accuracy of monetary control without imposing universal reserve requirements.

It provides for the payment of interest on reserves, albeit a lesser amount than the Federal Reserve would like, and would take the necessary step of authorizing the Federal Reserve Board to obtain, on a timely basis, whatever summary statistics it may require on the assets and liabilities of any depository institution.

The proposed amendment to H.R. 12706 provides for two other ways by which to improve monetary control. Specifically, it would tie the discount rate by formula to the Treasury bill rate; and second, establish statutory reserve requirement ratios for demand deposits and transactions balances. Many economists argue that discretionary changes both in the discount rate and in reserve requirements often are counterproductive and that open market powers are sufficient to conduct monetary policy effectively. I tend to agree.

The second basic question raised by the legislation before us is how to enhance equitable competition in our banking system. All of the proposals before us contemplate the Federal Reserve's charging competitive prices for its services. This change from the current practice of providing these services gratis will enable other suppliers of these services—including commercial banks offering correspondent services—to compete with the Federal Reserve on a more equal basis.

However, the payment of interest on reserves—which also is contemplated by all of the proposals before us—could have anticompetitive effects. In all fairness, shouldn't we also authorize all correspondent banks to pay interest on their respondents' deposits? If we don't, won't we have given the Federal Reserve an unfair advantage vis-a-vis commercial banks offering correspondent services?

The proposals before us also would restructure reserve requirements. The proposed amendment to H.R. 12706 would reduce them progressively. The Federal Reserve would change them to help middle-sized banks most of all, and large banks more than small ones. On this issue, I am on the side of the little guy, as always.

The proposed amendment to H.R. 12706 would treat savings accounts subject to automatic transfer and other transactions balances identically the same as demand deposits for reserve requirements' purposes.

The idea behind this approach is that it is neither necessary nor wise to link the payment of interest on any bank deposits which are effectively subject to withdrawal by check to a reduction in reserve requirements. However, that is what we will do if we don't treat transfer and transactions accounts the same as demand deposits for reserve requirements' purposes. Is this what we want to do? I think not.

Finally, I want to make clear that I am not unsympathetic to paying interest on reserves, provided that the budget deficit is not thereby unduly increased. However, I can think of many ways to spend a few hundred million dollars every year which are more appealing than paying interest on reserves.

A possible middle ground is delineated by the proposed amendment to H.R. 12706, which would limit the payment of interest on reserves to the amount that the Federal Reserve earns from discounting plus fees it is expected to charge for services. This seems about right to me.

In summary, the case for adopting H.R. 12706, with the proposed amendment, appears to be a strong one on all counts. However, I come to these hearings with an open mind.

If there is no objection, I would like to put my full statement in the record at this point.

[The complete opening statement of Mr. Mitchell follows:]

OPENING STATEMENT

of

THE HONORABLE PARREN J. MITCHELL
CHAIRMAN OF THE SUBCOMMITTEE ON DOMESTIC MONETARY POLICY

Hearings on

H.R. 13476, the Reserve Requirements Act of 1978
H.R. 13477, the Interest on Reserves Act of 1978
H.R. 12706, the Federal Reserve Membership Act of 1978

July 27, 1978

Good morning, ladies and gentlemen. This morning the Committee on Banking, Finance and Urban Affairs begins hearings on legislation dealing with Federal Reserve member bank reserves, the payment of interest thereon, and corollary questions. On June 26, 1978, the Democratic Caucus of this Committee resolved that these are matters for Congressional determination and called for "thorough legislative hearings." On July 7, the Federal Reserve forwarded its legislative proposals on these matters. My colleague, Mr. Reuss, the Chairman of this Committee, introduced H.R. 13476 and H.R. 13477, the Federal Reserve proposals, at the request of the Federal Reserve on July 14.

At the same time, he announced that the Committee would shortly hold hearings on the subject and that Mr. St. Germain and I, as Chairmen of the two subcommittees of relevant jurisdiction, would serve as co-chairmen pro tem for the hearings. Our Chairman also recommended that H.R. 12706 on Federal Reserve membership, which the ranking minority member of the Committee, Mr. Stanton of Ohio, introduced with co-sponsors in May, serve, together with a proposed amendment to it, as "the primary legislative vehicle at our upcoming hearings." I am pleased to co-chair these hearings.

Our ultimate purpose is to produce legislation that effectively improves the Federal Reserve's monetary control and promotes equitable competition in our banking system, without unduly increasing the Federal budget deficit. To accomplish these purposes, H.R. 13476 would extend statutory reserve requirements to all depository institutions and require them to make reports concerning their deposit liabilities and required reserves. H.R. 13477 would have Congress authorize the payment of interest on required reserves on deposit in Federal Reserve Banks. Additionally, the Federal Reserve contemplates charging for Federal Reserve services and restructuring reserve requirements.

On Improving Monetary Control

I am concerned, as I am sure all of us are, about the Federal Reserve's failure to hit its announced targets for M1 growth for more than a year now. But I am not convinced that either mandatory universal reserve requirements or the payment of interest on member bank reserves is needed to improve the accuracy of monetary control.

The proposed amendment to H.R. 12706 provides an alternative. It would improve the accuracy of monetary control without imposing universal reserve requirements. It provides for the payment of interest on reserves, albeit a lesser amount than the Federal Reserve would like. Moreover, the amendment would take the necessary step of authorizing the Federal Reserve Board to obtain, on a timely basis, whatever summary statistics it may require on the assets and liabilities of any depository institution. I am certain that these hearings will shed light on whether there is a compelling monetary policy need either to mandate universal reserve requirements or to provide incentives for Federal Reserve membership through the payment of interest on reserves at the expense of an increased budget deficit.

I remain educable on this subject, but currently lean toward the view that all the Federal Reserve needs to control the monetary aggregates, besides the will to do so, is more complete, timely information on deposits, other liabilities and assets of depository institutions, as provided for in the proposed amendment to H.R. 12706. I don't take seriously any argument that universal reserve requirements are needed. In regard to the need for membership, I cannot resist quoting from a July 1977 study prepared by Golembe Associates for the American Bankers Association:

> The continuing, and perhaps accelerating, decline in bank membership in the Federal Reserve System is a serious problem, largely for practical and political, rather than economic, reasons....In fact, careful studies indicate that precise control of the monetary aggregates is not harmed by nonmembership.

The proposed amendment to H.R. 12706 provides for two other ways by which to improve monetary control. Specifically, it would tie the discount rate by formula to the Treasury bill rate, and second, establish statutory reserve requirement ratios for demand deposits and transactions balances, including savings accounts which after November 1 will provide for automatic transfers to checking accounts.

Let me turn now to whether the Federal Reserve needs discretionary authority to set the discount rate and to change reserve requirements in order to conduct monetary policy effectively. Many economists think not. Indeed, they argue that discretionary changes both in the discount rate and in reserve requirements often are counterproductive. For example, in 1974, when we were experiencing our worst recession since the 1930s, the discount rate wasn't reduced until December, although the Treasury bill rate clearly had peaked in August. Surely, it would have been better if at that time the discount rate had been tied by formula to the Treasury bill rate.

In February 1975, testifying before the Senate Banking Committee, former Chairman of the Federal Reserve Board Arthur Burns pointed to reductions in reserve requirements, which released $2½ billion in reserves, as evidence that the Federal Reserve had been pursuing an expansionary policy since the preceding September. He said, "Reductions in member bank reserve requirements were also ordered -- in September, November, and January, releasing a total of nearly $2½ billion in reserves to the banking system." However, these changes were misleading indicators of the thrust of monetary policy. For during that period the Federal Reserve was using open market operations to drain an equivalent amount of reserves from member banks. The net result was that while the Federal Reserve was congratulating itself on being expansionary, the growth of the money supply was dropping precipitously and recessionary forces were thereby exacerbated. The point I am making is that the Federal Reserve fooled itself into thinking that its policies were expansionary because it had lowered reserve requirements when, in fact, they were contractionary.

Another kind of counterproductive change in reserve requirements occurred in September and October 1972 when, at a time when the forces of inflation were being unleashed, reserve requirements were reduced substantially. In the language of the Federal Reserve Board, the reductions were "designed to make reserve requirements of member banks and Federal Reserve check-collection procedures more equitable and more efficient." In other words, these were not monetary policy actions. However, they had monetary policy effects. The reductions powered the money supply upward, when what was needed was to slow down its growth. It was precisely the wrong action to take in 1972.

The Committee has to decide whether discretionary changes in the discount rate and reserve requirements are needed to conduct monetary policy or, as there is ample reason to believe, whether monetary control is best exercised only through open market operations. In this regard, it should be noted that we have no proposal before us which would limit, constrain or modify the Federal Reserve's open market powers in any way whatsoever. All in all, adopting H.R. 12706, with the proposed amendment, would appear to be the best way to provide for the improvement of monetary control.

On Promoting Equitable Competition In The Banking System

The second basic question raised by the legislation before us is how to enhance equitable competition in our banking system. All of the proposals before us contemplate the Federal Reserve's charging competitive prices for clearing checks, coin and currency pick-up and deliveries, wire transfers and safekeeping of securities. This change from the current practice of providing these services gratis definitely would improve competition in our banking system. It will enable other suppliers of these services to compete with the Federal Reserve on a more equal basis. These suppliers include commercial banks offering correspondent services, clearing houses and nonbank businesses.

However, the payment of interest on reserves, which also is contemplated by all of the proposals before us, could have anti-competitive effects. This is because Federal Reserve Banks are correspondent banks. Therefore, if the Federal Reserve is authorized to pay interest on the deposits of its respondents, then in all fairness, shouldn't we also authorize all correspondent banks to pay interest on their respondents' deposits? If we don't, won't we have given the Federal Reserve an unfair advantage vis-à-vis commercial banks offering correspondent services? I have not yet made up my mind on this particular issue. I hope that our witnesses will shed some light on it.

Competition also will be affected by the changes in reserve requirements, either by the proposed amendment to H.R. 12706 or by regulation as contemplated by the Federal Reserve. One difference between the two is that the proposed amendment is progressive: it releases proportionately more reserves as the size of the bank decreases. In contrast, the restructuring of reserve requirements contemplated by the Federal Reserve favors middle size banks over all, and large banks over small ones. Speaking personally, I always will be on the side of the little guy.

A second difference between the two concerns how they would treat automatic transfer accounts and other transactions balances for reserve requirement purposes. The Federal Reserve proposes either to treat automatic transfer accounts as time deposits or to lump them into a special category for reserve requirement purposes along with NOW accounts and share drafts. Either way, the reserve requirement would be lower than on demand deposits. The proposed amendment to H.R. 12706 would treat automatic transfer accounts as transactions balances and all transactions balances, in turn, as identically the same as demand deposits, since all are subject to withdrawal by check. Some might object that doing so will hold back the growth of interest-paying automatic transfer accounts, which are scheduled to be introduced this fall. There is an element of

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truth in this argument, but it is not persuasive. This is because, analytically, there really is no difference between allowing interest to be paid on demand deposits and allowing interest-paying automatic transfer accounts. Therefore, the question this Committee must resolve is whether it is necessary or wise to tie legislation which would allow the payment of interest on demand deposits to legislation that reduces reserve requirements. That is exactly what we will do if we fail to legislate treating demand and so-called transactions accounts as identically the same for reserve requirements purposes. Is this what we want to do? I think not.

Budgetary Impact of Paying Interest on Reserves

Finally, this Committee must resolve what restrictions, if any, should be placed on the payment of interest on member bank reserves. I am not unsympathetic to the proposal to pay interest on reserves, provided that the budget deficit is not thereby unduly increased. However, I can think of a lot of ways to spend a few hundred million dollars every year which are more appealing than paying interest on reserves. A possible middle ground is delineated by the proposed amendment to H.R. 12706, which would limit the payment of interest on reserves to the amount that the Federal Reserve earns from discounting plus the fees it is expected to charge for its services. This seems about right to me.

In summary, the case for adopting H.R. 12706, with the proposed amendment, appears to be a strong one on all counts. However, I come to these hearings with an open mind.

Mr. MITCHELL. This morning our witness is G. William Miller, the Chairman of the Federal Reserve Board. Welcome, Mr. Miller. As always, we are pleased to hear your views.

Before asking you to proceed, I want to ask Chairman Reuss and the other members if they have opening statements.

Chairman Reuss.

The CHAIRMAN. Thank you, Mr. Mitchell.

This morning the committee begins hearings on legislation to improve monetary control and the equity, efficiency, and competitiveness of our banking system.

Some of the proposals before us would have a significant impact on the budget. The proposals differ: from an open-ended authorization to pay out billions in one case, to a restriction of net direct-budget costs to a few tens of millions in another. In a time of budgetary austerity, these differences are important. We will view each proposal with a sharp eye on its potential budget costs.

The Federal Reserve has requested legislative action to help halt the erosion of membership in the Federal Reserve System. Member banks are leaving the system at a rate of 1.5 percent per year. Most of these banks are small: The median asset size of the last 50 banks to leave was about $25 million. It is estimated that total demand deposits of the last 50 banks to leave the system were under $1 billion. This suggests that the net effect, if any, of the erosion of membership on the Federal Reserve's degree of monetary control or the quality of Federal Reserve monetary data is small—and increasing only very slowly. In these hearings, we must ask not only, "How much does it cost to keep member banks in the Federal Reserve System?" but also, "Is membership worth it?". My answer to that latter question is, for three of the four proposals before us: "No."

Making Federal Reserve membership more attractive to commercial banks should not be an end in itself. We must hold down costs. We must insure that the proposal we pass promotes competitiveness and equity in our banking system. We must examine the contribution of each proposal to the effectiveness of monetary policy. We must evaluate the effect of each proposal on the safety of our financial institutions taken individually and as a whole. If Federal Reserve membership is not necessary to promote these goals, then it is not necessary at all.

We begin consideration today of three bills and a proposed amendment.

One, the first bill, H.R. 13476, introduced at the request of the Federal Reserve, would extend reserve requirements to demand deposits and transactions accounts, vaguely defined, in all depository institutions. It would also permit the Federal Reserve to collect information relevant to monetary control directly from these institutions.

H.R. 13476 closely resembles the bill first submitted to the Congress by then Chairman Arthur Burns of the Federal Reserve on January 25, 1974, a draft entitled "The Reserve Requirements Act of 1974," which would have extended requirements to all institutions receiving demand deposits on NOW accounts. This bill was never acted upon. In the Fine discussion principles, committee print of February 1976, the following principle was put forward:

All federally insured depository institutions would be required to meet reserve requirements on their deposit liabilities, and on their liabilities to other depository institutions.

However, in the bill introduced by Mr. St Germain and myself on April 7, 1976, H.R. 13077, which embodied the essential elements of the Fine study, the provision for mandatory reserve requirements on the deposit liabilities of all federally insured depository institutions was not included, largely because of the committee's view that nonbank depository institutions were subject to such limitations on the sources and uses of assets as to make reserve homogenization inequitable. It should be noted that the Federal Reserve noted the removal of this provision with regret. In a letter from Chairman Burns to the House Banking Committee, dated April 26, 1976, he said:

We also note with regret that H.R. 13077 fails to implement the Fine Discussion Principles calling for reserve requirements on the deposit liabilities of all Federally insured depository institutions, with such reserves to be held at the Federal Reserve. The Board continues to believe that such a system of universal requirements would contribute to the effectiveness of monetary policy.

Two, the second bill, H.R. 13477, also introduced at the request of the Federal Reserve, would authorize payment of interest on required reserves, limiting the total of such payments to 7 percent of the Federal Reserve banks' net earnings plus receipts from the sale of services to member banks. This limit would authorize net direct Treasury cost of more than $500 million per year.

Three, the third bill, H.R. 12706, has been introduced by Mr. Stanton and cosponsored by Messrs. Ashley, Hannaford, Barnard, Watkins, Wylie, Rousselot, McKinney, Hyde, Kelly, Steers, Evans, and Green. This bill provides for the following:

It would require the Federal Reserve to place individual prices on each of the services it offers. Currently, services are offered free to member banks, but at a cost of $410 million annually to the taxpayers according to Federal Reserve estimates. This measure would promote efficient production and use of these services. The Stanton bill, in calling for market-competitive prices on these services, assures that private competitiors of the Federal Reserve will not be undercut by unfair subsidized competition.

It authorizes the payment of interest on member bank reserves, at a rate determined by the Board but not exceeding the average yield of 3-month Treasury bills during the preceding quarter. The Stanton bill thus places a flexible limit on the rate of interest that can be paid, but not a dollar cap. It has the undesirable feature, in my view, of being somewhat open-ended: At current rates banks could receive over $2.2 billion per year in net benefits under the proposed formula.

It asks for a study of the impact of permitting member banks to invest some of their reserves in U.S. Treasury securities. This bill also calls for an annual report to the Congress by the Board on changes in membership, the pricing structure of services, and the interest rate structure on reserves in effect during the preceding year.

The fourth proposal before us is the proposed amendment to the Stanton bill, largely the work product of some of our highly respected less-senior members. This is designed to accomplish the basic goals of the Stanton and Federal Reserve bills—improved efficiency, competitive equity, and monetary control—while holding costs to the Treasury to a minimum. Frankly, Chairman Miller, in view of your own frequent admonitions about the Federal deficit, I think the substantially lower cost of the amendment to H.R. 12706 is a decided argument in its favor.

The amendment to H.R. 12706 has five distinct provisions:

First, the Federal Reserve would be authorized to pay interest on reserves up to a limit of the receipts from services and earnings from discounts and advances. This provision sets a tight limit on the cost of the overall program to the taxpayer.

Second, specific statutory reserve requirements would be established to replace the current reserve requirement ranges. Banks with under $10 million in demand deposits—over 60 percent of all banks—would be exempt from reserve requirements on transactions accounts altogether. For banks with more than $10 million a simplified progressive scale would be introduced. Under this provision, the burden of Federal Reserve System membership, which for most banks consists of the requirement that they hold sterile reserve balances, would be eliminated for the class of small banks who are now leaving the System.

Third, the discount rate would be tied to the average yield on 3-month Treasury bills issued in the past 2 weeks. This provision would lessen arbitrage possibilities and the danger of disruptive, unintended signals that is inherent in the current procedure for adjusting the discount rate.

Fourth, the Federal Reserve, under the amendment would be authorized to obtain the information it needs on nonmember savings and loans', and credit unions' assets and liabilities. It would put the arm on the specific regulatory agencies to get this information and pass it on posthaste and forthwith to the Fed.

Finally, the Fed would be required to transfer $575 million of its surplus to the Treasury. This is the same figure as the Fed came up with as an adjunct to its need, and it can be looked at as the surplus the Feds have—they pay $575 million and we pay $575 million, who could quarrel with that?

In terms of the cost, the cost under the proposed amendment is far, far less than either of the other two bills—although, of course, the universal reserve requirements of the Fed really costs nothing and is therefore less costly.

The net direct costs to the Treasury from the payment of interest on reserves would be limited to the diversion of earnings on discounts and advances from the Treasury to reserve-holding banks.

We estimate the savings over the Fed's proposal at around a third of a billion a year—ignoring the ripple effect on tax liabilities. These savings of a third of a billion reduce the budget deficit by a correspondingly amount, contributing to a goal which is in the minds of a great many of us.

Under the bill introduced by Mr. Stanton, H.R. 12706, interest could be paid on reserves held by member banks, up to the average 90-day Treasury bill rate. As I have said, it would have to go up $2.2 billion a year.

There are three questions which I would ask here:

First, are these levels of interest payment necessary?

Second, would they induce a bank verging on defection from the Fed to remain in? And third, if so, what will be the effect on monetary policy?

There are three answers to this, and I am going to just cover them.

One, in my belief, the levels of interest proposed by the Fed and in the Stanton bill are not necessary. They are too high. The overwhelming volume of interest payments would be made to very large banks which have no intention of leaving the Federal Reserve System.

For example, a $1 billion depository bank would get a payment in interest of $3 million a year from the taxpayers, and this seems to be quite a high price to pay.

In fact, the banks that have left the Fed have been almost exclusively small. The median asset size of the last 50 banks to leave the System was $25.7 million. Yet for every $1 in interest paid to banks susceptible to defection from the System, $3 would go to banks that are not.

Second, there is no evidence that banks on the margin of membership would be induced to return. We simply don't have any evidence on this. Such banks would certainly need to consider: first, the advantage of lower reserve requirements and higher interest payments on them available under State regulation; and second, the offsetting cost of having to pay for services provided by the Fed. These vary from case to case. And I would say, at this point, that it is surely significant that the small bankers are highly unenthusiastic about the interest on reserves proposal.

Third, the effect on monetary control would be indeed minimal. Even if H.R. 13477 is enacted in toto, and even if it completely halts the attrition of members, and even if this were highly important for monetary control—and it isn't—it would still be true that the incremental fraction of the money supply to come under the Fed's jurisdiction would be negligible to the point of invisibility.

At present, the Fed is losing demand deposits via defection at an annual rate of about $1 billion per year. This is less than the money supply growth often in a single week. The net direct and indirect cost to the U.S. Treasury would be over 70 cents for every dollar of demand deposits retained by the System.

So I have to ask: Why is it desirable to limit interest payments on member bank reserves to Federal Reserve earnings on discounts and advances, plus the gross receipts from the pricing of services?

This administration, right or wrong, has identified the federal budget deficit as a major source of inflationary pressure on the economy, it has committed itself to deficit reduction. Chairman Miller, you have pledged that you fully support this view in thought, word, and deed. Already, the President's proposed tax reduction package has been pared twice, and major social and defense spending programs have been cut back or delayed.

The present proposal, directly or indirectly, would cost the Treasury about $700 million a year.

Under the other proposal, the reduction in the reserves requirements—has a far greater relevance for the smaller banks who are inclined to leave the Federal Reserve System than under the Federal Reserve's own proposal.

Conclusion: Given the tightness of the budget, the Federal Reserve, in my judgment, has not made a sufficiently strong case to justify expenditure of the sums it proposes to spend on interest on reserves. The alternative proposal—the amendment to H.R. 12706—is far less costly and therefore, I believe, preferable.

From the standpoint of competitive equity and efficiency: The amendment to H.R. 12706 provides the best deal for the small banks. In this era of electronic fund transfer, NOW accounts, and international high-rolling, it is the small banks of this country who are feeling the competitive squeeze. It is small banks which are leaving the Federal Reserve System. The amendment to H.R. 12706 takes the pressure off these banks. It would enable them to earn market rates of interest on their reserves without quitting the Federal Reserve System. Nor would it require a massive subsidy from the U.S. taxpayers to the large banks. The amendment would also preserve an essential feature of competitive equity under present law: the flexibility that banks have to seek out their best regulatory bargain. Universal reserve requirements would effectively make this flexibility a dead letter.

Finally, on monetary control, the amendment as proposed to H.R. 12706 provides the greatest gain in the effectiveness of monetary policy per dollar of Treasury cost. It would solve the information problem, without imposing an overlapping regulatory jurisdiction on nonmember depository institutions. It would eliminate discrepancies between the discount and market interest rates, thereby cutting down on steadily increasing higher interests. It would eliminate the uncertainties now associated with abrupt, sporadic shifts in the discount rate.

The amendment eliminates the present flexible ranges of reserve requirements in favor of statutorily fixed ones, but this would not impair the effectiveness of monetary control. The Federal Reserve does not now use reserve requirements for monetary policy. To do so would be clumsy and imprecise. The reserves of the banking system and the cash held by the public can be controlled down to the last penny by open market operations. Why swing a meat ax, when you have a scalpel?

Are universal reserve requirements necessary for monetary control?

No, they are not. Monetary policy is conducted almost exclusively with open market operations: the buying and selling of U.S. Government securities by the New York Federal Reserve Bank. This occurs through a network of traders, independently of whether the transacting institutions are or are not members of the Federal Reserve System, of whether they are or are not subject to Federal Reserve-imposed reserve requirements, or of anything else. Reserve requirements are not altered for monetary policy purposes. Universal reserve requirements would have no impact on this aspect of monetary policy.

Reserves held do determine the multiplier relationship between the creation of reserves by open-market operations—the purchase of Government securities—and the creation of new money in circulation. This is an important relationship. It is, however, estimated statistically in practice and for this purpose any schedule of reserve requirements, universal or otherwise, is as good as any other. Since banks hold cash inventories whether they are subject to reserve requirements or not, there is no danger that exempting some classes of depository institutions from reserve requirements would destabilize the relationship between open-market operations and money creation.

Are flexible reserve requirements necessary for monetary control?

No; they are not. Since 1935, the Federal Reserve System has been empowered to adjust reserve requirements applicable to member banks within legislated bands. The proposed amendment would set reserve requirements for demand deposits and other transactions accounts of member banks at fixed levels. Six reasons for this change are:

One, the Federal Reserve does not need variable reserve requirements to conduct monetary policy; open-market operations are sufficient.

Two, the Federal Reserve, in practice, does not use changes in reserve requirements as a basic tool for the day-to-day implementation of monetaray policy. Changes in reserve requirements have been made at an average of once a year since 1935.

Three, the large, discrete changes in reserve requirements are a clumsy, imprecise way to change the money supply. Monetary policy would benefit from the elimination of this tool and by concentration on open-market operations as a means of controlling the money supply. Through open-market operations the monetary base can be controlled very precisely, releasing or contracting the reserves to the nearest penny.

Four, the two previous Chairmen of the Board of Governors have acknowledged that factors other than monetary developments have influenced Federal Reserve decisions concerning the use of reserve requirement changes. Both Chairmen cited the adverse impact of reserve requirement increases on the profitability of member banks relative to nonmember banks.

Five, the general trend in reserve requirement levels strongly suggests that the Federal Reserve has been sensitive to member bank profitability—resisting increases and yielding to member bank preferences for decreases. Since 1951, changes in reserve requirements, with few exceptions, have been in a downward direction. In 1951, the highest applicable reserve requirement was 24 percent and the lowest was 14 percent. Today, the highest marginal rate is 16¼ percent and the lowest is 7 percent, the lowest permissible under existing legislated bands.

Six, setting reserve requirements at fixed levels would eliminate a potential source of interference with Federal Reserve independence in the conduct of monetary policy, pressure from member banks to use reserve requirement changes selectively; namely, only when a change would be made in a downward direction whether in the best interest of proper monetary policy or not.

Safety: It is true that, while the amendment to H.R. 12706 meets the legitimate underlying policy concerns which have been identified with the question of Federal Reserve System membership, it does not resolve the question of membership itself. The Federal Reserve has maintained that the "viability" and "safety" of our banking system may be adversely affected if System membership continues to decline. So far, however, neither the Federal Reserve nor any outside expert has come forward with one scintilla of evidence to support this view.

I would be happy to have such evidence, if any exists. Are nonmember FDIC-insured banks less safe than member banks for depositors? If we add up the deposits of failed banks, which is the greater—that for nonmember or member banks? Are correspondent banking relationships less safe than the Federal Reserve's provision of services such as check-clearing? Do nonmember banks hold dangerously small cash inventories? Engage in less sound banking practices? Get on their regulatory agencies' danger lists more often? And if not, why does the Federal Reserve maintain that the safety of American banking is at stake.

Chairman Miller, may I personally welcome you before this committee. On July 18, I sent you a list of 16 questions, your answers to which will be of great assistance to us.

I ask unanimous consent that the 16 questions propounded by me to Chairman Miller on July 18, and to which he has furnished a reply, that both of them may be made a part of the record at this point.

Mr. MITCHELL. Without objection, they will be entered into the record following your complete opening statement.

[The complete opening statement of Chairman Reuss along with the referred to 16 questions submitted to Chairman Miller and his responses follow:]

OPENING STATEMENT OF

CHAIRMAN HENRY S. REUSS

COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS

U. S. HOUSE OF REPRESENTATIVES

AT HEARINGS ON THE MONETARY CONTROL AND THE

MEMBERSHIP PROBLEM

JULY 27, 1978

Room 2128 Rayburn HOB

This morning the Committee begins hearings on legislation to improve monetary control and the equity, efficiency and competitiveness of our banking system.

Some of the proposals before us would have a significant impact on the budget. The proposals differ: from an open-ended authorization to pay out billions in one case to a restriction of net direct budget costs to a few tens of millions in another. In a time of budgetary austerity these differences are important. We will view each proposal with a sharp eye on its potential budget costs.

The Federal Reserve has requested legislative action to help halt the erosion of membership in the Federal Reserve System. Member banks are leaving the System at a rate of 1.5 percent per year. Most of these banks are small: the median asset size of the last 50 banks to leave was about $25 million. It is estimated that total demand deposits of the last 50 banks to leave the System were under $1 billion. This suggests that the net effect, if any, of the erosion of membership on the Federal Reserve's degree of monetary control or the quality of Federal Reserve monetary data is small. (And increasing only very slowly.) In these hearings, we must ask not only, "How much does it cost to keep member banks in the Federal Reserve System?" but also, "Is membership worth it?". My answer to that latter question is, for three of the four proposals before us: "No".

Making Federal Reserve membership more attractive to commercial banks should not be an end in itself. We must hold down costs. We must ensure that the proposal we pass promotes competitiveness and equity in our banking system. We must examine the contribution of each proposal to the effectiveness of monetary policy. We must evaluate the effect of each proposal on the safety of our financial institutions taken individually and as a whole. If Federal Reserve membership is not necessary to promote these goals, then it is not necessary at all.

We begin consideration today of three bills and a proposed amendment.

1. The first bill, H.R. 13476, introduced at the request of the Federal Reserve, would extend reserve requirements to demand deposits and transactions accounts, vaguely defined, in all depository institutions. It would also permit the Federal Reserve to collect information relevant to monetary control directly from these institutions.

H.R. 13476 closely resembles the bill first submitted to the Congress by then-Chairman Arthur Burns of the Federal Reserve on January 25, 1974, a draft entitled "The Reserve Requirements Act of 1974", which would have extended reserve requirements to all institutions receiving demand deposits or NOW accounts. This bill was never acted upon. In the FINE discussion principles, Committee Print of Feb ~~June~~ 1976, the following principle was put forward:

> "All federally insured depository institutions would be required to meet reserve requirements on their deposit liabilities, and on their liabilities to other depository institutions."

However, in the bill introduced by Mr. St Germain and myself on April 7, 1976, H.R. 13077, which embodied the essential elements of the FINE study, the provision for mandatory reserve requirements on the deposit liabilities of all federally insured depository institutions was not included, largely because of the Committee's view that non-bank depository institutions were subject to such limitations on the sources and uses of assets as to make reserve homogenization inequitable. It should be noted that the Federal Reserve noted the removal of this provision "with regret". In a letter from Chairman Burns to the House Banking Committee, dated April 26, 1976, he said:

> We also note with regret that H. R. 13077 fails to implement the FINE Discussion Principle calling for reserve requirements on the deposit liabilities of all Federally insured depository institutions, with such reserves to be held at the Federal Reserve. The Board continues to believe that such a system of universal reserve requirements would contribute to the effectiveness of monetary policy.

2. The second bill, H.R. 13477, also introduced at the request of the Federal Reserve, would authorize payment of interest on required reserves, limiting the total of such payments to 7 percent of the Federal Reserve Banks' net earnings plus receipts from the sale of services to member banks. This limit would authorize a net direct Treasury cost of more than $500 million per year.

3. The third bill, H.R. 12706, has been introduced by Mr. Stanton and co-sponsored by Messrs. Ashley, Hannaford, Barnard, Watkins, Wylie, Rousselot, McKinney, Hyde, Kelly, Steers, Evans, and Green. This bill provides for the following:

A. It would require the Federal Reserve to place individual prices on each of the services it offers. Currently services are offered free to member banks but at a cost of $410 million annually to the taxpayers, according to Federal Reserve estimates. This measure would promote efficient production and use of these services. The Stanton bill, in calling for market-competitive prices on these services, assures that private competitors of the Federal Reserve will not be undercut by unfair subsidized competition.

B. It authorizes the payment of interest on member bank reserves, at a rate determined by the Board but not exceeding the average yield of 3-month Treasury bills during the preceding quarter. The Stanton bill thus places a flexible limit on the rate of interest that can be paid, but not a dollar cap. It has the undesirable feature, in my view, of being somewhat open-ended: at current rates banks could receive over $2.2 billion per year in net benefits under the proposed formula.

C. It asks for a study of the impact of permitting member banks to invest some of their reserves in U.S. Treasury securities. This bill also calls for an annual report to the Congress by the Board on changes in membership, the pricing structure of services, and the interest rate structure on reserves in effect during the preceding year.

4. The fourth proposal before us is the proposed amendment to the Stanton bill, largely the work product of some of our highly respected less senior members. This is designed to accomplish the basic goals of the Stanton and Federal Reserve bills -- improved efficiency, competitive equity, and monetary control -- while holding costs to the Treasury to a minimum. Frankly, Chairman Miller, in view of your own frequent admonitions about the Federal deficit, I think the substantially lower cost of the amendment to H.R. 12706, is a decided argument in its favor.

The amendment to H.R. 12706 has five distinct provisions:

a. The Federal Reserve would be authorized to pay interest on reserves, up to a limit of the receipts from services and earnings from discounts and advances. This provision sets a tight limit on the cost of the overall program to the taxpayer.

b. Specific statutory reserve requirements would be established to replace the current reserve requirement ranges. Banks with under $10 million in demand deposits -- over 60 percent of all banks -- would be exempt from reserve requirements on transactions accounts altogether. For banks with more than $10 million a simplified progressive scale would be introduced. Under this provision, the burden of Federal Reserve System membership -- which for most banks consists of the requirement that they hold sterile reserve balances -- would be eliminated for the class of small banks who are now leaving the System.

c. The discount rate would be tied to the average yield on 3-month Treasury bills issued in the past two weeks. This provision would lessen arbitrage possibilities and the danger of disruptive, unintended signals that is inherent in the current procedure for adjusting the discount rate.

d. The Federal Reserve would be authorized to obtain the information it needs on non-member depository institutions' assets and liabilities. This would solve the problem of monetary control. Rather than impose a vast new regulatory and reporting burden on non-member institutions, however, the amendment specifies that the needed information is to be collected through the good offices of existing regulatory agencies.

e. The Federal Reserve would be required to transfer $575 million of its surplus to the Treasury within two years rather than three. This is a bookkeeping transaction, designed to relieve the Federal Reserve of the embarrassment of holding excess cash.

In my opinion, the proposed amendment to H.R. 12706 provides the best deal -- for the taxpayer, for the competitive equity of our banking system, and for improved monetary control. The question of the safety of our banking system is, I think, an important one -- but I have seen no evidence that any of the proposals would affect bank safety one iota for better or for worse.

Cost: The amendment to H.R. 12706 is far less costly than either H.R. 13477 or H.R. 12706, unamended, though H.R. 13476, universal reserve requirements is, to be sure, less costly.

Under the amendment, net direct costs to the Treasury from the payment of interest on reserves would be limited to the diversion of earnings on discounts and advances from the Treasury to reserve-holding banks. These earnings totaled $40 million last year, and would be even lower under the procedures prescribed in the amendment. This compares with an estimated direct Treasury cost of $355 million annually under H.R. 13477, and, as noted, the open-ended possibility of expenditures running into billions under the Stanton bill. Indirect costs from reducing reserve requirements are the same under either H.R. 13477 or H.R. 12706, amended.

Under the Federal Reserve proposal (H.R. 13477), as explained in the memorandum accompanying Chairman Miller's letter of July 6, 1978, interest would be paid on required balances held at Federal Reserve banks as follows:

First $25 million: 1/2 percentage point below the average return on the FRS portfolio, valued at book. If the 1977 return on the Fed portfolio is used as a benchmark, the rate of interest would be 6 percent. (Of course it would be higher in the present environment.)

Above $25 million: 2 percent interest per annum. Under H.R. 13477, interest payable would be limited to the sum of:

-- receipts from fees on services

-- 7 percent of the net earnings of the F. R. banks.

The Federal Reserve estimates interest payouts would total $765 million per year on the basis of current member bank deposits and 1977 System earnings. Of this, $410 million would be recouped from service charges. Net direct Treasury cost: $355 million. The Federal Reserve estimates that an additional $80 million in Treasury savings should be deducted from this figure, on the assumptions that (1) without the legislation, current rates of attrition would continue and (2) the program would result in a halt in the attrition of Federal Reserve membership.

Under the Stanton bill (H.R. 12706), interest could be paid on reserves held by member banks, up to the average 90-day Treasury bill rate of the preceding calendar quarter. The estimated net cost of going to this limit, after deducting service receipts is $2.2 billion.

Are these levels of interest payment necessary? Would they induce a bank verging on defection from the Federal Reserve System to remain in? If so, what will the effect on monetary policy be?

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These three questions have the following answers.

1. The levels of interest proposed by the Fed and in the Stanton bill are not necessary.

Under the Federal Reserve's proposal and *a fortiori* under the Stanton bill, the overwhelming volume of interest payments would be made to large banks which have no intention of leaving the Federal Reserve System.

Some Sample Payments Under H.R. 13477:

Banks with demand deposits of:	Payment:
$ 10 million	$ 42,000
$100 million	$ 420,000
$400 million	$1,680,000
$ 1 billion	$3,380,000

Total Payments to Banks in Particular Size Categories

All Banks with Total Demand Deposits:	Payment:	Avge/bank:
under $10 million (3,220 banks)	$ 58 M.	$ 18,000
$10 - $100 million (2,074 banks)	$186 M.	$ 89,000
over $100 million (332 banks)	$521 M.	$1,569,000

The banks that have left the Federal Reserve System have been almost exclusively small. The median asset size of the last 50 banks to leave the System was $25.7 million; 45 of the 50 had assets under $100 million -- that is, *demand* deposits well under

$50 million. Yet for every dollar in interest paid to banks susceptible to defection from the System, $3 would go to banks that are not.

2. <u>There is no evidence that banks on the margin of membership would be induced to return.</u>

The Federal Reserve has simply not presented evidence to Congress on this point. Such banks would need to consider:

a) The advantage of lower reserve requirements and higher interest payments on them available under state regulation.

b) The offsetting cost of having to pay for services provided by the Federal Reserve System.

These vary from case to case.

In this context, it is surely significant that the small bankers (Independent Bankers Assn.) are not enthusiastic about the interest on reserves proposal.

3. <u>The effect on monetary control would be minimal.</u>

Finally, assuming that (a) H.R. 13477 is enacted, (b) it completely halts the attrition of members from the Federal Reserve System, and (c) that this were important for monetary control, which it is not, it would still be true that the incremental fraction of the money supply to come under Federal Reserve jurisdiction would be negligible to the point of invisibility. At present, the Federal Reserve is losing demand deposits via defection of members at an annual rate of only about $1 billion per year. This is less than the money supply often grows in a single week. The net direct and indirect cost to the U.S. Treasury would be over 70 cents for every dollar of demand deposits retained by the System.

Why is it desirable to limit interest payments on member bank reserves to Federal Reserve earnings on discounts and advances, plus the gross receipts from the pricing of services?

This Administration, right or wrong, has identified the Federal Budget deficit as a major source of inflationary pressure on the economy, and has committed itself to deficit reduction. Chairman Miller of the Federal Reserve Board supports this view. Already, the President's proposed tax reduction package has been pared twice, and major social and defense expenditure programs have been cut back or delayed.

In this atmosphere competition for the Federal dollar is severe, and priorities must be established and followed. The key question is, therefore, how important is it to spend scarce Federal resources on a plan to stimulate membership in the Federal Reserve System? Chairman Miller of the Federal Reserve has given four reasons in favor of such a plan:

1. It would decrease the fraction of the nation's payments handled "outside the safe channels of the Federal Reserve". But: The Federal Reserve has presented no evidence to substantiate the implied claim that the correspondent banking relationships employed by most banks outside the Federal Reserve are any less safe than the services provided by the Federal Reserve.

2. It would increase the number of banks with access to Federal Reserve Bank credit facilities. Whenever the discount rate is below market, access to the discount window is certainly a

blessing for member Federal Reserve banks...at taxpayer's expense. It is also true that in times of crisis, the discount window may be used to forestall the collapse of a bank, such as Franklin National, until major holders of uninsured CD's have cashed in and bailed out. But: Whether this is wise policy or within the spirit of Federal deposit insurance laws is an open question. Improved access to the discount window would have trivial affects on monetary control.

3. It would reinforce a "national presence in bank supervisory and regulatory functions". But: At the present time, nonmember state banks are regulated by the Federal Deposit Insurance Corporation. Inducing such banks to become System members merely transfers the "national presence" from the FDIC to the Federal Reserve. This strengthens the national presence only if the Federal Reserve regulates better than the FDIC, a presumption for which no evidence has been offered.

4. It would make implementation of monetary policy easier. Here, the Federal Reserve has offered support for its position. The argument is that the present network of reporting member banks provides too incomplete a data base on which to base monetary policy decisions. This is true. But: The problem could be cured, with minimal expense, by requiring all national depository institution regulators to collect the necessary data and forward it to the Federal Reserve on a timely basis. The amendment to H.R. 12706 would do this.

The Federal Reserve's proposal would cost the U.S. Treasury, directly and indirectly, about $700 million per year. Under the proposed amendment to H.R. 12706, the payment of interest on reserves would be limited to the $410 million income from services, plus about $40 million (the 1977 figure) in earnings from discounts and advances. Only the latter represents a direct drain on Treasury funds. Indirect costs, stemming from the reduction of reserve requirements, are the same under H.R. 13477 and H.R. 12706 (amended) -- about $350 million. However, under the latter proposal the reduction of reserve requirements is far greater, relatively, for the smaller banks who are inclined to leave the Federal Reserve System than under the Federal Reserve's own proposal.

Conclusion: Given the tightness of the budget, the Federal Reserve has not made a sufficiently strong case to justify expenditure of the sums it proposes to spend on interest on reserves. The alternative proposal -- the amendment to H.R. 12706 -- is far less costly and therefore preferable.

Competitive Equity and Efficiency: The amendment to H.R. 12706 provides the best deal for the small banks. In this era of EFT, NOW accounts, and international high-rolling, it is the small banks of this country who are feeling the competitive squeeze. It is small banks which are leaving the Federal Reserve System. The amendment to H.R. 12706 takes the pressure off these banks. It would enable them to earn market rates of interest on their reserves without quitting the Federal Reserve System. Nor would it require a massive subsidy from U.S. taxpayers to the large banks. The amendment would also preserve an essential feature of competitive equity under present law: the flexibility that banks have to seek out their best regulatory bargain. Universal reserve requirements would effectively make this flexibility a dead letter.

In addition, payment of interest on reserves, coupled with charges for services, would enable the Federal Reserve to improve the efficiency of the provision of services at only a very modest net cost to either the taxpayer or the banking system.

Would universal reserve requirements enhance "competitive equity" between member and non-member institutions?

The Federal Reserve asserts that imposition of uniform, universal reserve requirements on all depository institutions would place such institutions on a "more equal" competitive basis. There are two main reasons why this claim does not stand up.

1. Depository institutions do not operate on an equal competitive footing in many respects aside from unequal reserve requirements. Savings and Loan institutions, for example, may not be required to hold sterile balances at a reserve bank, but they are subject to limitations on their portfolio of assets that do not apply to commercial banks. Imposing compulsory sterile reserve requirements on these institutions merely makes them worse off; it does not make the system more equal unless S & L's were signifi-

cantly better off than commercial banks beforehand. If this is the case, it has assuredly not been demonstrated by the Federal Reserve.

2. The Federal Reserve provides services to member banks free of charge; these services compensate those institutions for the burden of holding sterile reserve balances. Membership in the Federal Reserve System is voluntary: if a bank's costs of membership exceed the benefits, it can switch to a state charter and leave. Many banks do not leave. Conclusion: for those banks, the value of services provided by the Federal Reserve exceeds the cost of reserve requirements. There is therefore no "burden" of membership for these banks.

But what about non-member banks, and non-bank depository institutions? Non-member banks are those for whom Federal Reserve membership is too costly. Universal reserve requirements merely force these banks to accept a bad bargain into which they would not voluntarily enter. And for non-bank depository institutions, the situation is worse: such institutions have no more standing to join the Federal Reserve System or gain access to its services than the corner drugstore even if they would be made better off by doing so. Universal reserve requirements would make their operations more costly, with no offsetting benefits.

Conclusion: Universal reserve requirements do not reduce the "burden" on member banks, who are member voluntarily; they merely make life harder for all non-member institutions. Only non-bank depository institutions, which do not have the option of membership even if they wanted it, can be said to be inequitably treated under present law. Universal reserve requirements would make them worse off, and would therefore detract from, not enhance, competitive equity.

Monetary Control: The amendment to H.R. 12706 provides the greatest gain in the effectiveness of monetary policy per dollar of Treasury cost. It would solve the information problem, without imposing an overlapping regulatory jurisdiction on non-member depository institutions. It would eliminate discrepancies between the discount and market interest rates, thereby insuring that banks could not turn a profit by borrowing below-market at the discount window to obtain reserves on which they would then earn a near-market return from the Federal Reserve. It would eliminate the uncertainties now associated with abrupt, sporadic shifts in the discount rate.

While, for reasons of competitive equity, the amendment to H.R. 12706 eliminates the present flexible ranges of reserve requirements in favor of statutorily fixed ones, this would in no way impair the effectiveness of monetary control. The Federal Reserve does not now use reserve requirements for monetary policy. To do so would be clumsy and imprecise. The reserves of the banking system and the cash held by the public can be controlled down to the last penny by open market operations. Why swing a meat ax, when you have a scalpel?

Are universal reserve requirements necessary for monetary control?

No, they are not. Monetary policy is conducted almost exclusively with open market operations: the buying and selling of U.S. government securities by the New York Federal Reserve Bank. This occurs through a network of traders, independently of whether the transacting institutions are or are not members of the Federal Reserve System, of whether they are or are not subject to Federal Reserve-imposed reserve requirements, or of anything else. Reserve requirements are not altered for monetary policy purposes. Universal reserve requirements would have no impact on this aspect of monetary policy.

Reserves held do determine the multiplier relationship between the creation of reserves by open-market operations (the purchase of government securities) and the creation of new money in circulation. This is an important relationship. It is, however, estimated statistically in practice, and for this purpose any schedule of reserve requirements, universal or otherwise, is as good as any other. Since banks hold cash inventories whether they are subject to reserve requirements or not, there is no danger that exempting some classes of depository institutions from reserve requirements would destabilize the relationship between open market operations and money creation.

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No, they are not. Since 1935, the Federal Reserve System has been empowered to adjust reserve requirements applicable to member banks within legislated bands. The proposed amendment would set reserve requirements for demand deposits and other transactions accounts of member banks at fixed levels. Six reasons for this change follow:

1. The Federal Reserve does not need variable reserve requirements to conduct monetary policy; open market operations are sufficient.

2. The Federal Reserve, in practice, does not use changes in reserve requirements as a basic tool for the day-to-day implementation of monetary policy. Changes in reserve requirements have been made at an average of once a year since 1935.

3. The large, discrete changes in reserve requirements are a clumsy, imprecise way to change the money supply. Monetary policy would benefit from the elimination of this tool and by concentration on open market operations as a means of controlling the money supply. Through open market operations the monetary base can be controlled very precisely, releasing or contracting reserves to the nearest penny.

4. The two previous Chairmen of the Board of Governors have acknowledged that factors other than monetary developments have influenced Federal Reserve decisions concerning the use of reserve requirement changes. Both Chairmen cited the adverse impact of reserve requirement increases on the profitability of member banks relative to non-member banks.

5. The general trend in reserve requirement levels strongly suggests that the Federal Reserve has been sensitive to member bank profitability -- resisting increases and yielding to member bank preferences for decreases. Since 1951, changes in reserve requirements, with few exceptions, have been in a downward direction. In 1951, the highest applicable reserve requirement was 24 percent and the lowest was 14 percent. Today, the highest marginal rate is 16¼ percent and the lowest is 7 percent, the lowest permissible under existing legislated bands.

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I would be happy to have such evidence, if any exists. Are non-member FDIC-insured banks less safe than member banks for depositors? If we add up the deposits of failed banks, which is the greater -- that for nonmember or member banks? Are correspondent banking relationships less safe than the Federal Reserve's provision of services such as check-clearing? Do non-member banks hold dangerously small cash inventories? Engage in less sound banking practices? Get on their regulatory agencies danger lists more often? And if not, why does the Federal Reserve maintain that the safety of American banking is at stake?

Chairman Miller, may I personally welcome you before this Committee. On July 18, I sent you a list of sixteen questions, your answers to which will be of great assistance to us. If in your statement this morning you have not fully answered all of them, I would appreciate your doing so.

QUESTIONS SUBMITTED BY CHAIRMAN HENRY S. REUSS TO CHAIRMAN G. WILLIAM MILLER, ALONG WITH CHAIRMAN MILLER'S RESPONSES

1) Could you give us a complete breakdown of the costs of the various services the Fed now provides to commercial banks?

The cost breakdown below provides a detailed listing of the direct and indirect costs of those services provided to member banks and to the public. These data are for 1977 and are taken from the Federal Reserves' Planning and Control System Expense Report (PACs). The total expense of check and automated clearinghouse operations (ACHs) is the total of service lines 4, 5, 6, and 7 in the table below.

	Service Line: 1977	PACs Cost ($ millions)
	Services to Members:	
1.	Currency (with shipping, w/o note issue)	90.5
2.	Coin (with shipping)	30.5
3.	Transfer of Reserve Account Balances	19.6
4.	ACH Operations	6.7
5.	Check Processing (w/o shipping)	194.8
6.	Intradistrict Transportation	21.9
7.	Interdistrict Transportation	8.4
8.	Securities - Purchase and Sale	.6
9.	Securities - Safekeeping	17.7
10.	Securities - Clearing	3.3
11.	Reserve Accounts - Settlement	15.7
12.	Noncash Collection	7.1
	Subtotal	416.8
	Other Services:	265.1
	System Total (including shipping):	681.9

2) Could you further breakdown the classification in Question 1 into member and nonmember banks? Would you describe fully the services rendered to nonmembers, such as those provided through automatic clearinghouses.

The Planning and Control System (PACS) of the Federal Reserve Banks does not collect data on the amount of services provided to each individual bank using the services. PACS also does not allocate costs by individual user of services. Thus, a further breakdown of services provided to member and nonmember banks is unavailable.

ACH Services

Nonmember banks that are members of local clearinghouse associations for which the Federal Reserve provides clearing and settlement services may originate and receive payments through the ACH. When acting as an originating bank the nonmember may send to the ACH charges or credits, recorded on magnetic tape, for delivery to other financial institutions which participate in the ACH. The Federal Reserve clearing and settlement operation receives magnetic tapes from originating banks, sorts the payment instructions by receiving financial institution, makes the appropriate charges or credits to designated member bank reserve accounts, and delivers the payment instructions to the receiving financial institution.

A nonmember bank acting as a receiving financial institution, may receive the payments instructions in either magnetic tape or computer printed listing format delivered to its premises or any other location mutually acceptable to that bank and the Federal Reserve.

Check Collection Services

All non-member banks which pay checks at par receive deliveries or presentments of cancelled checks from the Federal Reserve in the normal process of check clearing. As in ACH deliveries the delivery or presentation site may be bank premises or any other location acceptable to both the bank and the Federal Reserve.

Non-member banks desiring to clear checks they receive from customers which are drawn on other banks may deposit at Federal Reserve offices only checks drawn on other banks located in the same regional check processing center (RCPC) geographical area. These RCPC checks must be deposited by 12:01 a.m. and funds are made available through credits to the reserve account of a member bank on the processing day which commenced at the deposit deadline.

Federal Reserve offices process checks drawn on bank located in a variety of specifically designated geographical areas which include Regional Check Processing Center, City, Country and Inter-office designations. Not all Federal Reserve offices service all these types of designated geographic areas.

There are 48 Federal Reserve offices which process checks. Of these offices 44 have designated RCPC areas, 15 have designated country areas and 43 have designated city areas. All Federal Reserve check processing operations are similar. Checks are received from eligible banks, sorted by paying bank, and delivered or presented to the paying bank.

Currency and Coin Services

Non-member banks receive and send shipments of currency and coin from and to Federal Reserve Banks and Branches. A shipment preparation fee is assessed to each non-member that utilizes this service. Charges and credits for currency and coin shipments and fees are made to the reserve accounts of designated member banks.

3) Would you provide estimates of the effects on Federal Reserve membership of:

   a) the reduction in reserve requirements that has occurred since 1970
   b) the two phase reductions in reserve requirements submitted to us in the Federal Reserve proposal of July 6
   c) the reduction in reserve requirements from the proposed amendment to H.R. 12706.

None of the three reserve requirement reductions fully offsets the burden of membership for all member banks or for all banks within a given size class. It is very difficult to determine the effect on Federal Reserve membership of any action that does not fully offset the burden for a given class of banks, and therefore, the impact on membership of these three reserve requirement reductions cannot be determined. The possible effect would be to reduce the rate of attrition from what it otherwise would be.

The impact on membership is especially uncertain for the reserve requirement reductions since 1970. The average required reserve ratio for member bank deposits has been reduced somewhat since 1970. On the other hand, state reserve requirement ratios have also declined, partially offsetting the effects of the Federal Reserve actions. More important, interest rates in the seventies have been consistently higher than in periods prior to 1970 and have raised the opportunity cost of holding sterile reserves. Hence, cost of membership probably has increased for most banks over the past decade despite the reduction of reserve requirements.

Both the reductions in reserve requirements in the Federal proposal and that in the proposed amendment to H.R. 12706 would partially offset the burden of membership for some banks and therefore might reduce attrition somewhat. However, neither can be expected to stop attrition.

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4) What will be the effect on membership of paying interest on reserves?

   a) under H.R. 13477
   b) under H.R. 12706
   c) under the proposed amendment to H.R. 12706

Payment of a market interest rate on member bank reserves--as proposed in (b)--would fully eliminate the burden of Federal Reserve membership and should, therefore, halt membership attrition. Indeed, depending on the scope of access by depository institutions to Federal Reserve Bank services, payment of a full market rate could induce most nonmember institutions to join the System. Payment of less than a market rate, as contemplated in (a) and (c), would not halt attrition unless combined with other features which compensate member banks sufficiently to offset the burden of membership.

5) What will be the joint effect on membership of the reserve requirement reductions and the interest payments of the preceding two questions?

The combined impact of reserve requirement reductions and payment of interest on reserves, in conjunction with changes for System services under H.R. 13477 would be to offset the burden of Federal Reserve membership, on average, for all member banks. It is probable that this plan will not fully offset the burden for every individual member bank, so that some may still choose to leave the System. On the other hand, after the plan goes into effect, some nonmembers may find Federal Reserve membership attractive and choose to join the System. On balance, membership attrition should halt under the Federal Reserve proposal.

H.R. 12706 would tend to make membership attractive to virtually all depository institutions eligible for membership. Therefore, the fact that the Stanton bill also requires Federal Reserve Banks to provide payments and other operational services to all depository institutions would not adversely affect membership--although the pricing provisions of the Stanton bill are unduly restrictive and could lead to a reduction in payments services provided to the banking system.

The reduction in reserve requirements and the interest payments proposed under the amendment to H.R. 12706, when combined with the effects of pricing of services and opening access to all depository institutions, would not be sufficient to offset the membership burden. Membership attrition would continue and may even accelerate, since a member could withdraw and still enjoy all of the benefits of membership (except access to the discount window), while also earning a market rate of return on the reserves released by withdrawal.

6) Explain exactly how you believe the erosion in membership up to now has interfered with the Federal Reserve's ability to conduct monetary policy. Explain how the further erosion of membership would interfere with the Federal Reserve's ability to conduct monetary policy?

Membership erosion has weakened the Federal Reserve's ability to conduct monetary policy for the following reasons: (1) A stable relationship between reserves and the money stock facilitates implementation of monetary policy. However, nonmember reserve requirements are beyond the oversight of the Federal Reserve. The resulting differential reserve requirements have weakened the reserve-to-money stock relationship. (2) An effective monetary policy requires use of the discount window to lessen the uneven impact of policy changes on individual banks. Since nonmember banks do not have direct access to the discount window, the Federal Reserve may be precluded from adopting appropriate monetary policies if increasing numbers of banks cannot cushion their adjustments to, for example, tightening credit conditions through regular, and reliable, day-to-day access to the discount window. (3) An effective monetary policy depends on up-to-date information about the size of the money stock. However, accurate information about the current money stock only becomes available with an average two-quarter lag. The difference between the initial estimate and the final benchmark estimate of M-1 has varied by as much as two billion dollars with an average error without regard to sign of 700 million dollars over the last ten years.

7) The Federal Reserve's money supply is now growing, and has been growing since early 1977, outside the target bands given to the Congress pursuant to H. Con. Res. 133 prior to November 1977 and pursuant to the Federal Reserve Reform Act of 1977 after that. Would the Fed have been able and willing to slow down its money growth if it had more member banks, or is the relationship between faster monetary growth and the number of member banks irrelevant? Please analyze fully.

The faster growth in M-1 since early 1977 could have been more easily identified and contained from a technical point of view if considerably more deposits were held within the Federal Reserve System. It is probable that actual money growth would have been reduced somewhat under the circumstances. For example, now that all benchmark adjustments have been completed for the first three quarters of 1977, M-1 in that period has been revised upward by between $1.4 and $2.0 billion as a result of initial mis-estimates of nonmember bank deposits. The Federal Reserve would have been able to respond to this higher level sooner had the full extent of growth been observed promptly.

8) Explain why you believe the erosion of membership up to now has jeopardized the safety of individual commercial banks or the banking system as a whole. Explain how the erosion of member banks in the future could jeopardize the safety of individual member banks or the banking system as a whole.

Declining membership means increasing liquidity risk for the banking system as a whole, since fewer banks have ready, direct access to the discount window to meet unexpected withdrawals or demands for credit or to cushion themselves against temporary liquidity pressure during periods of general stringency. Furthermore, membership attrition may result in some increases in the riskiness of the banking system as the proportion of the banking system's assets held as risk free reserves at Reserve Banks is reduced.

Current law and Board procedures specifically allow for emergency credit to nonmember institutions, including even non-depository institutions; however, no nonmember institution has borrowed from the Federal Reserve since 1966. The infrequency of discount window borrowing by nonmembers may be attributed primarily to two factors. First, the Federal Reserve can lend to nonmembers on collateral other than U.S. Government securities only under emergency circumstances--when the nonmember is unable to obtain credit from other sources and when failure to lend to the nonmember would adversely affect the economy. Second, in view of these emergency conditions, most nonmembers have no doubt been reluctant to seek Federal Reserve credit since to do so would label them as being in serious financial difficulty. If such lending became public knowledge, it could generate a run on the uninsured deposits of the bank, further worsening the bank's financial condition.

It is important to note that the private market cannot easily perform the discount window's function. For example, for a bank suffering a liquidity crisis, alternative forms of short-term credit, such as Federal funds, may become unavailable at precisely the time they are needed most. Furthermore, in times of general stringency, the private banking system may be incapable of mobilizing the needed amount of funds.

9) Do you believe that nonmember banks are less safe and more liable to go bankrupt than member banks? What has the record been? List the banks, and their total assets, that have failed since 1945, classified by member and nonmember status.

The record of bank failure since 1947, the earliest data available in FDIC Annual Reports, shows that 0.72 per cent of the average number of member banks operating during 1947 to 1977 failed during that period. In contrast, 1.33 per cent of the average number of nonmember banks operating in the period failed.

Table 1
Insured Banks That Have Required FDIC Disbursement 1/
1947-1977

Bank Name	Location (city, state)	Date of failure	Charter class 2/	Total assets ($1,000)
First National Bank of	Evanston, WY	1/13/47	N	$1,803
First National Bank of	Lemont, IL	1/27/47	N	1,666
Central City National Bank	Central City, PA	7/14/47	N	1,693
Peoples Bank of	Donalds, SC	12/1/47	NM	762
Lyons State Bank	Lyons, WI	12/8/47	NM	874
Columbus Trust Company	Newark, NJ	7/24/48	SM	7,893
American National Bank of Pryor Creek	Pryor, OK	11/22/48	N	1,774
First State Bank	Franklin, TX	12/18/48	SM	694
First National Bank of	Dyer, IN	2/21/49	N	3,157
Stockmens Bank of	Martinsdale, MT	5/3/49	NM	634
Citizens Banking Company	Weston, OH	6/13/49	NM	740
Farmers & Merchants State Bank	Spencerville, IN	10/10/49	NM	354
Westphalia State Bank	Westphalia, MI	4/3/50	NM	744
Bank of Aurora	Aurora, NC	7/24/50	NM	1,291
Farmers First National Bank of	Minooka, IL	8/14/50	N	1,332
First National Bank in	Cecil, PA	10/9/50	N	638
Brazeau Bank	Brazeau, MO	1/22/51	NM	144
Parnassus National Bank	New Kensington, PA	8/25/51	N	2,906
Thomasville Bank & Trust Company	Thomasville, AL	1/21/52	NM	1,031
Camden State Bank	Camden, IL	5/5/52	NM	838
Bank of Dierks	Dierks, AR	9/2/52	NM	583
Mayfield State Bank	Mayfield, PA	2/13/53	NM	1,355
First State Bank of	Elmwood Park, IL	5/26/53	NM	17,456
Bank of Ila	Ila, GA	8/9/54	NM	98
Bank of Whitesville	Whitesville, KY	10/1/54	NM	1,040
First National Bank of	Lewisville, TX	1/27/55	N	721
Rathdrum State Bank	Rathdrum, ID	4/30/55	NM	1,017
Bank of North Idaho	Priest River, ID	4/30/55	NM	1,101
Joshua Momument National Bank of	Twentynine Palms, CA	7/25/55	N	3,111
Frontier Trust Company	Fort Fairfield, ME	10/3/55	NM	6,036
River Oaks State Bank	Fort Worth, TX	10/15/56	NM	5,202
Home National Bank of	Ellensville, NY	12/4/56	N	7,712
First State Bank of	Yorktown, TX	4/10/57	SM	1,253
First National Bank of	Halfway, OR	3/17/58	N	1,446
Peoples State Bank	Richland Springs, TX	5/5/58	NM	618
Rushville Banking Company	Rushville, OH	5/26/58	NM	4,476
Manufacturers' Bank of	Edgewater, NJ	7/17/58	NM	2,365
Bartlett State Bank	Bartlett, NE	5/13/59	NM	570
Liberal State Bank	Liberal, MO	6/9/59	NM	1,012
First State Bank	Tenaha, TX	12/3/59	NM	1,277
Capitol Hill State Bank	Oklahoma City, OK	7/29/60	NM	7,506
Sheldon National Bank	Sheldon, IA	1/16/61	N	4,365
Bank of Earlsboro	Earlsboro, OK	8/11/61	NM	962
Bank of Ochlochnee	Ochlochnee, GA	9/7/61	NM	984
First National Bank of Maud	Maud, OK	12/19/61	N	1,626
First State Bank	Premont, TX	12/30/61	SM	1,882
First State Bank of	Westmont, IL	5/24/63	NM	7,055
Chatham Bank of Chicago	Chicago, IL	8/23/63	NM	19,124
First National Bank of	Marlin, TX	3/10/64	N	3,741
State Savings Bank of	Minden City, MI	3/17/64	NM	1,310
First State Bank	Dell City, TX	7/4/64	NM	1,237
Belleview Valley Bank	Belleview, MO	7/20/64	NM	1,285
Frontier Bank	Covelo, CA	7/31/64	NM	2,642
Crown Savings Bank	Newport News, VA	9/4/64	NM	7,865

Table 1 (continued)

Bank Name	Location (city, state)	Date of failure	Charter class 2/	Total assets ($1,000)
Nebraska State Bank of	Valentine, NE	10/29/64	NM	7.769
Brighton National Bank	Brighton, CO	1/22/65	N	3,015
San Francisco National Bank	San Francisco, CA	1/22/65	N	54,061
Winona State Bank	Winona, TX	2/5/65	NM	479
Malone State Bank	Malone, TX	2/25/65	NM	589
First State Bank	Covington, TX	4/5/65	NM	606
Five Points National Bank	Miami, FL	1/12/66	N	2,703
Citizens Bank	Pottsville, AR	1/24/66	NM	832
Blanket State Bank	Blanket, TX	1/31/66	NM	1,257
Saguache County National Bank	Saguache, CO	3/17/66	N	512
Bank of Gray Summit	Gray Summit, MO	4/7/66	NM	1,935
Public Bank	Detroit, MI	10/12/66	NM	110,077
First State Bank of	Tuscola, TX	10/17/66	NM	3,330
Bank of Pine Apple	Pine Apple, AL	1/31/67	SM	4,289
Southern Bank of	St. Petersburg, FL	2/17/67	NM	2,884
Sacul State Bank	Sacul, TX	6/23/67	NM	762
Cedar Vale National Bank	Cedar Vale, KS	7/7/67	N	4,058
Lorenzo State Bank	Lorenzo, TX	2/13/68	NM	6,159
Central National Bank of	Jacksonville, FL	5/27/68	N	13,445
Bank of Commerce	Tonkawa, OK	9/25/68	NM	5,551
Rocky Mountain Bank	Lakewood, CO	2/6/69	NM	8,617
Citizens State Bank	Alvarado, TX	4/12/69	NM	2,556
Morrice State Bank	Morrice, MI	5/6/69	SM	2,283
First State Bank	Dodson, TX	5/12/69	SM	1,134
State National Bank	Lovelady, TX	5/28/69	N	4,136
First National Bank of	Ursa, IL	8/20/69	N	2,053
Big Lake State Bank	Big Lake, TX	8/22/69	NM	4,750
First State Bank	Aransas Pass, TX	9/5/69	NM	11,417
First National Bank of	Coalville, UT	10/10/69	N	6,625
State Bank of	Prairie City, IA	2/22/70	NM	4,130
Peoples State Savings Bank	Auburn, MI	4/18/70	NM	10,877
Farmers Bank of	Petersburg, KY	6/25/70	NM	1,074
Eatontown National Bank	Eatontown, NJ	8/7/70	N	21,417
First State Bank of	Bonne Terre, MO	8/24/70	NM	8,003
City Bank of	Philadelphia, PA	9/3/70	NM	10,775
Berea Bank and Trust Company	Berea, KY	10/8/70	NM	5,871
Sharpstown State Bank	Houston, TX	1/25/71	NM	78,903
Birmingham-Bloomfield Bank	Birmingham, MI	2/16/71	NM	109,739
Farmers State Bank of	Carlock, IL	2/17/71	NM	2,196
Bank of Salem	Salem, NE	4/5/71	NM	679
First National Bank of	Cripple Creek, CO	11/30/71	N	1,301
First Community State Bank of	Savannah, MO	12/30/71	NM	3,701
Surety Bank & Trust Company	Wakefield, MA	5/19/72	NM	22,054
Delta Security Bank & Trust Company	Ferriday, LA	1/19/73	NM	9,780
Skyline National Bank	Denver, CO	3/26/73	N	6,527
Elm Creek State Bank	Elm Creek, NE	5/7/73	NM	3,186
First State Bank	Vernon, TX	7/16/73	NM	16,242
First National Bank of	Eldora, IA	10/5/73	N	8,072
United States National Bank	San Diego, CA	10/18/73	N	1,265,868
American Bank & Trust	Orangeburg, SC	9/20/74	NM	147,137
Tri-City Bank	Warren, MI	9/27/74	SM	16,295
Franklin National Bank	New York, NY	10/8/74	N	3,655,662
Cromwell State Savings Bank	Cromwell, IA	10/9/74	NM	3,502
Swope Parkway National Bank	Kansas City, MO	1/3/75	N	7,576
Northern Ohio Bank	Cleveland, OH	2/19/75	NM	103,782
Franklin Bank	Houston, TX	3/24/75	NM	20,690
Chicopee Bank & Trust Company	Chicopee, MA	5/9/75	NM	11,406

Table 1 (continued)

Algoma Bank	Algoma, WI	5/30/75	NM	5,176
Bank of Picayune	Picayune, MS	6/18/75	NM	18,049
Bank of Chidester	Chidester, AR	7/1/75	NM	2,449
State Bank of Clearing	Chicago, IL	7/12/75	SM	74,354
Astro Bank	Houston, TX	10/16/75	NM	5,471
American City Bank & Trust Company, N.A.	Milwaukee, WI	10/21/75	N	147,563
Peoples Bank of the Virgin Islands	St. Thomas, Charlotte Arnalie, VI	10/24/75	NM	14,879
Peoples Bank	Willcox, AZ	12/19/75	NM	5,657
First State Bank of	Jennings, KS	12/27/75	NM	2,898
Bank of Bloomfield	Bloomfield, NJ	1/10/76	NM	31,652
Bank of Woodmoor	Woodmoor, CO	1/12/76	NM	4,033
Hamilton National Bank of	Chattanooga, TN	2/16/76	N	412,107
South Texas Bank	Houston, TX	2/25/76	NM	7,756
First State Bank of Northern California	San Leandro, CA	5/21/76	NM	56,018
Northeast Bank of	Houston, TX	6/3/76	NM	18,141
First State Bank of Hudson County	Jersey City, NJ	6/14/76	NM	14,072
Mt. Zion Deposit Bank	Mt. Zion, KY	6/25/76	NM	507
Coronado National Bank	Denver, CO	6/25/76	N	2,613
Citizens State Bank	Corrizo Springs, TX	6/28/76	NM	17,410
New Boston Bank & Trust Company	Boston, MA	9/14/76	NM	6,662
American Bank & Trust Company	New York, NY	9/15/76	SM	224,502
Hamilton Bank & Trust Company	Atlanta, GA	10/8/76	NM	40,075
Centennial Bank	Philadelphia, PA	10/19/76	NM	13,670
First State Bank & Trust Co.	Rio Grande City, TX	11/19/76	NM	13,754
International City Bank and Trust Company	New Orleans, LA	12/3/76	NM	176,320
First State Bank	Foss, OK	3/10/77	NM	1,850
Monroe Bank and Trust Company	Monroe, CT	3/28/77	NM	4,054
First Augusta Bank & Trust Company	Augusta, GA	5/20/77	NM	23,711
Republic Nat'l Bank of Louisiana	New Orleans, LA	7/29/77	N	9,164
Donahue Savings Bank	Donahue, IA	8/26/77	NM	5,288
Banco Economias	San German, PR	9/2/77	NM	179,410

Source: FDIC Annual Reports, 1947-1977.

1/ Disbursements by the FDIC to protect depositors are made when the insured deposits of banks in financial difficulties are paid off, or when the deposits of a failing bank are assumed by another insured bank with the financial aid of the Corporation. In deposit payof cases the disbursement is the amount paid by the Corporation on insured deposits. In deposit assumption cases the principal disbursement is the amount loaned to failing banks, or the price paid for assets purchased from them; additional disbursements are made in those cases as advances for protection of assets in process of liquidation and for liquidation expenses.

2/ Charter class designations are: N = National bank, member of Federal Reserve System, SM = State member bank, NM = commercial non-member bank, MI = non-member mutual savings bank

Table 2

Summary of Insured Commercial Bank Failures By Charter Class
1947-1977

Year	Failure of All Insured Banks		Failure of Federal Reserve Member Banks						Failure of Nonmember Banks	
			All Member Banks		State Member Banks		National Banks			
	Number	Assets	Number	Assets	Number	Assets	Number	Assets	Number	Assets
1947	5	6,798	3	5,162	0	0	3	5,162	2	1,636
1948	3	10,361	3	10,361	2	8,587	1	1,774	0	0
1949	4	4,885	1	3,157	0	0	1	3,157	3	1,728
1950	4	4,005	2	1,970	0	0	2	1,970	2	2,035
1951	2	3,050	1	2,906	0	0	1	2,906	1	144
1952	3	2,452	0	0	0	0	0	0	3	2,452
1953	2	18,811	0	0	0	0	0	0	2	18,811
1954	2	1,138	0	0	0	0	0	0	2	1,138
1955	5	11,986	2	3,832	0	0	2	3,832	3	8,154
1956	2	12,914	1	7,712	0	0	1	7,712	1	5,202
1957	1	1,253	1	1,253	1	1,253	0	0	0	0
1958	4	8,905	1	1,446	0	0	1	1,446	3	7,459
1959	3	2,859	0	0	0	0	0	0	3	2,859
1960	1	7,506	0	0	0	0	0	0	1	7,506
1961	5	9,819	3	7,873	1	1,882	2	5,991	2	1,946
1962	0	0	0	0	0	0	0	0	0	0
1963	2	26,179	0	0	0	0	0	0	2	26,179
1964	7	25,849	1	3,741	0	0	1	3,741	6	22,108
1965	5	58,750	2	57,076	0	0	2	57,076	3	1,674
1966	7	120,646	2	3,215	0	0	2	3,215	5	117,431
1967	4	11,993	2	8,347	1	4,289	1	4,058	2	3,646
1968	3	25,155	1	13,445	0	0	1	13,445	2	11,710
1969	9	43,571	5	16,231	2	3,417	3	12,814	4	27,340
1970	7	62,147	1	21,417	0	0	1	21,417	6	40,730
1971	6	196,519	1	1,301	0	0	1	1,301	5	195,218
1972	1	22,054	0	0	0	0	0	0	1	22,054
1973	6	1,309,675	3	1,280,467	0	0	3	1,280,467	3	29,208
1974	4	3,822,596	2	3,671,957	1	16,295	1	3,655,662	2	150,639
1975	13	419,950	3	229,493	1	74,354	2	155,139	10	190,457
1976	16	1,039,292	3	639,222	1	224,502	2	414,720	13	400,070
1977	6	223,477	1	9,164	0	0	1	9,164	5	214,313
Total	142		45		10		35		97	

10) On November 1 of this year, Federal Reserve regulations will allow funds deposited with member banks to be automatically transferred from savings accounts to demand deposits. Would you estimate the amount of demand deposits that will be transferred by depositors into savings accounts, as a result of this regulation during the first year.

The extent to which depositors will shift funds from demand to savings accounts in the year after introduction of this new service is quite uncertain. It will depend on the structure of service charges and the promotional strategies adopted by banks--few of which have been announced to date--as well as on the speed with which the public takes advantage of the added flexibility in cash management.

If banks choose to offer automatic transfers with minimal service charges, then consumers might choose to react to the availability of such accounts in ways similar to their reaction to NOW accounts in their introductory stage, so that the NOW account experience in New England can be used to infer a reasonable upper limit on the timing and magnitude of the shift of deposits. However, it is likely that the service charges associated with automatic transfers will be much higher than for NOW's, and hence the shift in the first year may be considerably less than in the New England NOW experience.

11) Would you estimate the effective dollar limit on the interest that could be paid on reserves under H.R. 13477 over the next ten-year period?

Many assumptions have to be made to arrive at the extended projections requested. System revenue projections depend on, among other factors, currency in circulation, System service volumes, net expenditures for providing these services, the volume of reserves held with System, and the average level of interest rates. The size of these factors could either expand or contract depending on legislation affecting the financial industry and the changing condition of the economy as well as on membership in the System. These uncertainties would tend to make any specific estimate misleading, but it is probable that the dollar limit will rise as the System portfolio grows in an expanding economy. A reasonable range of estimates for the dollar limit a decade from now may be on the order of $700 to $900 million.

12) In H.R. 13476, the Federal Reserve asks for a form of universal reserve requirements. How would monetary policy have been improved if these universal reserve requirements had been in effect over the last ten years?

Given the quantity of reserves supplied by the Federal Reserve, the associated variability of the monetary aggregates is heightened by unpredictable deposit flows between member and nonmember banks. Such flows alter the volume of reserves available to support deposits at nonmember banks which, in conjunction with differential reserve requirements between member and nonmember banks, forces the money stock away from the FOMC's targeted objective under a reserves operating target. Ongoing research suggests that the per cent error in M-1 for two-month growth rates due to such interbank flows would have ranged between roughly plus or minus 3.6 per cent at an annual rate in 1968 under a reserves operating target. This error would have risen to plus or minus 4.7 per cent in 1978. If universal reserve requirements had been imposed in 1968, the associated variability in M-1 for short-run policy periods under a reserves operating target probably would have fallen significantly.

The imposition of universal reserve requirements in 1968 also would have provided the Federal Reserve with more timely information about deposits held at nonmember banks. The average error in the initial estimate of M-1 (see question 6) would have been reduced by sizeable amounts--about $700 million over the period from 1968 to 1977.

13) Do you think the need for Federal Reserve membership to enhance the Federal Reserve's ability to conduct monetary policy would vanish if universal reserve requirements were imposed?

Universal reserve requirements would be an important step toward improving the Federal Reserve's control over the monetary aggregates, particularly if all required reserves were held in the form of deposits with the Federal Reserve or in currency and coin, as is currently the case for member banks. Nevertheless, Federal Reserve membership would continue to be important, as full access to the discount window is necessary to temper the impact of monetary disturbances on the monetary aggregates and the availability of bank credit and perhaps to aid in averting a monetary crisis. In addition, a Federal Reserve presence in the payments mechanism is vital for maintaining an efficient and effective system nationwide and in reducing the exposure of the payments system to disruptions which could adversely affect the monetary supply and bank credit.

14) The ten largest banks in the U.S. hold 32 per cent of the reserve balances on deposit with Federal Reserve banks. Considering these large banks individually, from Bank of America with its 67.2 billion in deposits (December 31, 1977) to the tenth largest bank, Security Pacific National Bank, Los Angeles, with its 14.9 billion in deposits, estimate the size of the individual annual payments that each would receive under:

a) H.R. 13477
b) H.R. 12706
c) the proposed amendment to H.R. 12706

The attached table shows the payments on reserves, service charges and net payments (payments on reserves minus service charges) under the three plans. Compensation payments under H.R. 13477 result from the reduced reserve requirement structure on demand deposits, described in the Board's "Preliminary Proposal" on the membership plan, and interest payments of 6 per cent (1/2 percentage point below the average return on the Federal Reserve System portfolio) on the first $25 million of required reserve balances at Federal Reserve Banks and 2 per cent on balances in excess of $25 million. Under H.R. 12706 compensation payments would be based on the average 91-day bill rate in the preceding quarter. The rate used in this analysis was the average 91-day Treasury bill rate for the first quarter of 1977, 4.55 per cent. Compensation payments under the proposed amendment to H.R. 12706 would be limited to service charges collected.

Service charges assessed each bank are identical under the three plans. The annual amount of System services used by each of the ten banks was estimated from survey data and valued at direct and indirect Federal Reserve costs, as shown in the PACs accounting system. Check, ACH, wire transfer, currency, coin, reserve accounting, securities-handling and noncash collection are the services assumed to be priced. However, the service charges shown here are only illustrative and do not necessarily reflect prices that might be charged by the Reserve Banks.

The amendment to H.R. 12706, while limiting payments on required reserves to revenues generated from pricing, does not mention how the revenues collected are to be distributed among banks. It is assumed in the tables that 1.5 per cent is paid on reserve balances, a rate which exhausts collected revenues from pricing.

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ANNUAL PAYMENTS TO THE 10 LARGEST MEMBER BANKS
($ MILLIONS)

H.R. 13477

	Compensation Payments	Service Charges	Net Payments
Bank of America	$ 26.0	$ 10.9	$ 15.1
Citibank	15.2	5.8	9.4
Chase	26.3	6.2	20.1
Manufacturers Hanover	10.2	7.5	2.7
Chemical	4.9	5.9	(1.0)
Morgan Guaranty	7.3	2.7	4.6
Continental	15.0	6.1	8.9
Security Pacific	14.4	4.5	9.9
Bankers Trust	10.5	3.5	7.0
1st National Bk. Chicago	16.4	4.6	11.8
TOTAL	$ 146.2	$ 57.7	$ 88.5

H.R. 12706

	Compensation Payments	Service Charges	Net Payments
Bank of America	$ 58.0	$ 10.9	$ 47.1
Citibank	33.6	5.8	27.8
Chase	58.8	6.2	52.6
Manufacturers Hanover	22.2	7.5	14.7
Chemical	10.3	5.9	4.4
Morgan Guaranty	15.7	2.7	13.0
Continental	33.1	6.1	27.0
Security Pacific	31.7	4.5	27.2
Bankers Trust	22.8	3.5	19.3
1st National Bk. Chicago	36.3	4.6	31.7
TOTAL	$ 322.5	$ 57.7	$ 264.8

PROPOSED AMENDMENT TO H.R. 12706

	Compensation Payments	Service Charges	Net Payments
Bank of America	$ 19.1	$ 10.9	$ 8.2
Citibank	10.9	5.8	5.1
Chase	19.2	6.2	13.0
Manufacturers Hanover	7.2	7.5	(.3)
Chemical	3.2	5.9	(2.7)
Morgan Guaranty	5.0	2.7	2.3
Continental	10.8	6.1	4.7
Security Pacific	10.3	4.5	5.8
Bankers Trust	7.4	3.5	3.9
1st National Bk. Chicago	11.9	4.6	7.3
TOTAL	$ 105.0	$ 57.7	$ 47.3

15) Describe and estimate the cost of services provided to member banks which are part of a holding company which has nonmember affiliates that share in these services.

The Federal Reserve Planning and Control System (PACS) has no provision for allocating costs for services to the users of those services. However, the Federal Reserve recently collected data on the use of check collection services by individual member banks for the month of May 1978. These data are currently being analyzed, and information on the cost of check services provided to member banks which are part of a holding company will become available at a later date.

16) In the testimony of Philip E. Coldwell before the Committee on Banking, Housing and Urban Affairs, U.S. Senate, May 25, 1978, he said "this (erosion of membership) threatens to weaken our financial system, as more and more of the nation's payments and credit transactions are handled outside the safe channels of the Federal Reserve....". In what way, if any, are the private businesses now providing services which compete with those provided by the Federal Reserve unsafe?

The present payments system, including private inter-bank clearings, is quite safe. However, one effect of membership attrition is that more and more of the nation's payments and credit transactions are handled through correspondent banks rather than through the Federal Reserve. Since nonmember banks must maintain correspondent balances to facilitate payments settlement (and also must generally keep additional balances to compensate the correspondent for clearing and settlement services provided to the respondent) and since the settlement function is more efficient the more respondents are served by a single, large correspondent, there is a tendency for "pyramids" of banks and correspondent deposits to form. Insolvency of an important bank at or near the apex of such a pyramid would immobilize the settlement (and compensating) balances of numerous banks lower in the pyramid, which could lead to dangerous illiquidity for these respondent banks. There, of course, is no such risk of insolvency when settlement balances are held at Federal Reserve Banks. Federal Reserve clearing channels are in this sense inherently "safer".

The CHAIRMAN. I thank you for giving me this time.

Mr. MITCHELL. The Chair will now recognize the ranking minority member, Mr. Stanton, for an opening statement.

Mr. STANTON. Thank you, Mr. Chairman.

First, I would like to commend the chairman of the full Banking, Finance and Urban Affairs Committee, Mr. Reuss, for scheduling these series of hearings into examining the subject of the Federal Reserve membership.

As you know, I have been deeply concerned about this issue for several years. Particularly, I am concerned about the far-reaching effects of the vitality of the Fed and the Nation's monetary system, as more and more banks continue to leave the Federal Reserve System.

Specifically, the possible implications which flow from this problem, and some of the proposals for its solution, include the following:

One, the Fed's control over monetary policy may be weakened. Presently, the Fed's staff estimates that the Fed membership controls only about 72 percent of all of the bank deposits, which greatly contributes to continual errors in the Fed's estimate of the money supply. As membership continues to decline, this margin of error will increase.

Two, the Nation could face risks of liquidity problems. Declining membership means that an ever-increasing number of banks lose their ready, direct access to the discount window. As access to the discount window provides adjustment credit and liquidity in times of special need, this vital mechanism for insuring the smooth operation of the banking system during liquidity crises may become less effective.

Third, the structure of the Federal financial regulatory system could be altered in the process of attempting to solve the membership problem. The Federal Reserve's proposal for universal reserve requirements would bring more depository institutions under the jurisdiction of the Fed's regulatory framework. Chairman Reuss has proposed for the discount window statutorily fixed reserve requirements. On the other hand, this would significantly change the existing role of the Congress and the Fed in the conduct of monetary policy.

Obviously, all of these questions are highly complex. Nonetheless, the schedule established for these hearings, and the witnesses invited, will enable us to give each of these issues a thorough consideration, as it deserves.

At the outset, I wish to have it clearly understood that I personally enter these hearings with an open mind. My bill, the Federal Reserve Membership Act of 1978, represents just one approach toward stopping the downward trend in membership.

However, I am anxious and eager to learn more about Chairman Reuss' amendments, as well as the Fed's proposals. The two major provisions of my bill are: the explicit pricing of Federal Reserve payments services, and the payment of interest on required reserves.

Payment of interest on reserves would enable member banks to turn their presently vital reserves balances into investments, yielding a more competitive rate of return.

The pricing of payments services would seek to promote increased efficiency within the Fed, and greater competition within the banking industry as a whole.

Other issues raised by the Reuss amendment and the Fed's proposal include, of course, adjustment of reserve requirements; limit on Treasury; revenue loss; improvement of data available to the Fed for the conduct of monetary policy; and alterations in the discount rate.

Admittedly, some of these proposals are more appealing than others. For example, I am pleased that we will consider lowering the existing reserve requirements and improving the flow of monetary reports to the Fed.

However, the Reuss amendments and the discount window, and the statutory fixed reserve requirements, cause me, of course, great concern.

Throughout my almost 14 years as a member of this committee, I have consistently maintained that we should not restrict the flexibility of the Federal Reserve. And these amendments, of course, appear to do precisely that.

Moreover, my preliminary analysis indicates that the proposal on the discount rates is directed at a truly nonissue. Chairman Reuss has stated that tying the discount rate to the Treasury bill rate would reduce the possibilities for reduced profits in discount operations.

Presently, however, the charge for membership to member banks on this transaction is negligible, as the Fed polices these operations and only rarely grants such activities on a case-by-case basis.

Finally, I wish to compliment you, Mr. Miller, on the Fed's efforts, and on your proposals that you presented to us. I have had a chance to look at your statement last night. I think you have summarized the issue quite well in your final remarks when you state that: "This morning, we are dealing with matters of crucial importance to the longrun viability of the Nation's central banks, to the health of the Nation's depository institutions, and indeed to the Nation's economy."

And I can only say, in conclusion, Mr. Chairman, that I would hope that as we all enter this subject with an open mind, that we not necessarily consider this on the subject of "loss of money to the Treasury," or "gain of money to the Treasury"; but that we would keep in mind that, in the last 65 years of the Federal Reserve Board System, that this Congress that we are so proud of, our predecessors 65 years ago, set for the Federal Reserve Board certain basic responsibilities in setting up this system.

We require many things of them for monetary policy and the safety of our banking system, and that is our concern, and I think we should keep that uppermost in our mind as we give the Fed the opportunity and the tools to provide the lessons that we need in carrying out the goal that we have set for them.

And so, Mr. Chairman, I thank you for this opportunity and look forward to these hearings.

Mr. Mitchell. Thank you.

Welcome, Chairman Miller. You have been welcomed three times. As always, we are pleased to hear your views, and the Chair will now ask that you proceed.

STATEMENT OF HON. G. WILLIAM MILLER, CHAIRMAN, BOARD OF GOVERNORS, FEDERAL RESERVE SYSTEM

Mr. Miller. First, I think I should say not only for myself personally, but on behalf of the Board of Governors, how much we appreciate this opportunity. I am indebted to you, Mr. Mitchell, for being willing to schedule these hearings at this time; and to Chairman Reuss for allowing this matter to go forward so late in the session. I am most appreciative of Congressman Stanton's efforts—continuing efforts—to address the matter of membership and to bring his proposal forward; and of the efforts of other committee members who have co-sponsored this proposal as a basis for discussion.

I realize how difficult it is, in a busy session of Congress with many issues to consider, to take up something this important so late, and therefore I am particularly grateful.

When I came to the Federal Reserve in March, and when I appeared before this committee on March 9 on the first full day of my new assignment, in answer to a question at that time I pointed out that I thought the so-called "membership issue" was critical and deserved attention, and that it was my hope and expectation to bring forward for discussion some plan by the middle of the year.

And here we are, and we have made considerable progress. I believe that all of us are approaching this matter objectively, recognizing that it is a complex and important issue. And because there are many complexities, there are many alternative proposals.

We are approaching these hearings and this discussion as a process for sorting out ideas to find the optimum system to accomplish all of our objectives—a balanced, well thought through approach, taken not for the purpose of aiding any constituency, but for the public benefit.

I might add, Mr. Chairman, that the Senate also has been responsive to this important issue. Senator Proxmire has introduced a single bill combining the two bills suggested by the Federal Reserve, that is: universal reserves and the authority to pay in interest on reserves a total amount of up to 7 percent of Federal Reserve earnings, plus the amount collected by the Federal Reserve for its services. This bill will be taken up in the Senate Banking Committee in a few weeks. And so, there is parallel action being taken by the House and Senate.

The attrition of membership in the Federal Reserve is occurring because member banks are at a serious competitive disadvantage relative to other depository institutions. This attrition, as it continues, dilutes the effectiveness with which the Federal Reserve can fulfill its monetary and other objectives.

Therefore, I would like to discuss first the dimensions and the effects of this decline in membership, and then to comment on the particular items in the legislation that has been proposed.

The problem facing us is the continuing decline in System membership in recent years. Over the past 8 years, 430 member banks have withdrawn from the System, while only 103 nonmember banks have joined. By looking at chart I attached to my testimony it is easy to see graphically the large attrition in membership. In 1977, 69 banks chose to give up membership, and 39 more banks have withdrawn during the first half of this year. This last statistic probably understates the trend, because many member banks appear to be delaying their plans for withdrawal until they see what actions the System and the Congress take to resolve this membership problem.

Most of the banks withdrawing from membership have been small, as some of you pointed out, with total deposits under $50 million.

But a disturbing tendency has developed recently for larger banks to leave the System. If you compare the top and bottom of chart II, you can see that in recent years there has been a definite shift and that larger and larger banks are withdrawing. A bank with deposits as large as $750 million has withdrawn fairly recently. So there is this trend toward withdrawal of large banks. Fifteen of the 69 banks leaving the System in 1977 had deposits of more than $100 million, a record number for that size of bank. The steady downward trend in the number of member banks has been accompanied, of course, by a decline in the proportion of bank deposits subject to Federal Reserve requirements, as you can see in chart III. The number of banks—the bottom line—is declining, and deposits are going down rapidly also. At the end of 1977, member banks held less than 73 percent of the commercial bank deposits, down about 8 percentage points in the last 8 years. Thus, more than one-fourth of commercial bank deposits and over three-fifths of all banks are outside the Federal Reserve System.

In New England, where the development of NOW accounts in the past 5 years has greatly sharpened the competition among depository institutions, the decline in membership and in deposits held by member banks has been even more dramatic, which you can see in chart IV. The share of deposits in New England held by member banks fell by 11 percentage points in the last 3 years alone, from 73 percent at the end of 1974 to less than 62 percent at the end of last year. If you look at the chart you can see how quickly that decline is taking place. Notice also that New England some years ago had higher ratios of both numbers of banks and deposits than nationwide; now it is lower. That again illustrates the trend that is of concern.

The basic reason for the decline in membership is the financial burden that membership entails. Most nonmember banks and thrift institutions may hold their required reserves in the form of earning assets or in the form of deposits—such as correspondent balances—that would be held in the normal course of business. Member banks, by contrast, must keep their required reserves entirely in nonearning form. The consequences, as may be seen in chart 5, is that member banks hold a greater percentage of their total assets in nonearning form than do nonmember banks. Chart V shows that members—at the top line—have a much higher percentage of their assets that are not yielding any income.

The cost burden of Federal Reserve membership thus consists of the earnings that member banks must forego because of the extra amount of assets they are required to hold. Of course, member banks are provided with services from the Federal Reserve, but the value of these services does not, by any means, close the earnings gap between members and nonmembers. As a result, the earnings rate for member banks runs persistently below that for nonmember banks. If you glance for just a moment at chart VI and you will notice that nonmembers are consistently earning more on their assets than members.

The Board staff estimates that the aggregate cost burden for Federal Reserve membership may exceed $650 million annually, based on data for the year ending September 1977; that is about 9 percent of member bank profits before taxes.

The burden of membership is not distributed equally across all sizes of member banks, according to our estimates, which are shown in chart VII. The relative burden is greatest for small banks—as some of you pointed out—exceeding 20 percent of profits for banks with less than $10 million in deposits. The top of that chart shows the aggregate burden, but in the bottom panel you will see that the burden does fall more on the smaller institutions.

The competitive inequality caused by sterile reserve balances can be regarded as an additional "tax" levied upon member banks. This tax produces Federal Reserve earnings that are paid over to the Treasury and thereby become additional revenue to the U.S. Government. But this tax is inherently unfair because it falls only on member banks. Nonmember banks and thrift institutions, both of which compete with members in many of the same markets for deposits and loans, do not pay this tax. Member banks naturally attempt to minimize the added burden of sterile reserves, but there are practical limitations in their ability to do so. Those banks most successful in taking such steps are the larger banks. Because of their size, the character of their business, and their managerial resources, these banks have access to sources of funds or to activities that involve lower reserve requirements. Moreover, such banks are usually large correspondent banks that provide services to smaller banks, including those that are based upon access to Federal Reserve facilities.

Requiring sterile reserves only from member banks is an inefficient way to raise revenue for the Treasury, because it leads to withdrawal from the System, resulting in reduction in Treasury revenues. For example, since 1970, the withdrawals of member banks have reduced Federal Reserve earnings in 1977 by nearly $200 million from what they would have been had the banks not withdrawn.

In chart VIII you can see the annual loss in Federal Reserve earnings as a result of the withdrawal of banks since 1970. This has reduced the net income to the Treasury by about $100 million. Remember, this goes back only to 1970, and does not project future loss.

It is obvious from the continuing erosion in Federal Reserve membership that more and more banks are becoming acutely aware of the cost burden of membership and of the competitive handicap arising from that burden. The cost of membership is due in part to the high interest rates being induced by inflation in recent years. With market interest rates exceeding 5 percent for much of the past decade, the earnings opportunities foregoing by holding required reserves at Reserve banks has been painfully clear to member banks.

At the same time, competitive pressure on banks have increased. Banks once had a virtual monopoly on transaction accounts because of their ability to offer demand deposits. But this unique position is being eroded. Financial innovations have led to widespread use of interest-bearing accounts at nonbank depository institutions as well as banks for transaction purposes.

Since 1970, these innovations have included such activities as limited preauthorization of bill-paying from savings accounts at banks and savings and loan institutions, NOW accounts that are available in New England, the credit union share drafts, telephone transfers from savings deposits, and the use of electronic terminals to make immediate transfers to and from savings accounts. Growth of these transactions-related interest deposits has been most dramatic in recent years. For example, NOW accounts have grown from almost zero in 1974 to nearly 8 percent of household deposit balances in New England in 1977. Chart IX shows the very rapid dramatic growth of deposits in NOW accounts.

There is no sign that the intense competition for transaction accounts will abate. These heightened competitive forces are compelling all depository institutions to be more cost sensitive and to seek ways to maintain their profitability. Experience shows that withdrawal from the Federal Reserve System is a strategy that many bank managements have chosen in these circumstances.

The declining trend in membership is of great concern, because as it continues it will inevitably weaken our financial system in a number of ways.

Declining membership threatens to alter the character of the Federal Reserve System as an institution from that which Congress originally intended. Congress intended the Nation's central bank to provide needed liquidity and to establish an efficient payments system, among other purposes. All commercial banks were made eligible to participate in the governance and the services of the regional Reserve banks. Membership in the System was not restricted to national banks alone because the System's designers in Congress considered broad representation from all classes of banks located in every region in the country to be essential to the System's functioning in the public interest. They especially wished to avoid over-representation by the largest banks. Moreover, in founding the System, Congress hoped that State-chartered banks would join in order to strengthen both the System and the ability of State banks to serve their communities.

These purposes are as valid today as they were 65 years ago, but continued attrition of membership could defeat these congressional goals. If current trends continue, membership in the Federal Reserve will consist predominantly of the very largest banks and of the smaller national banks who might choose for one reason or another not to convert to State charters. The monetary and other policies of the Federal Reserve would then have their most immediate impact on a relatively small part of our financial system.

As fewer and fewer banks and a smaller share of the Nation's deposits remain with the Federal Reserve System, the ability of the System to influence the Nation's money and credit becomes weaker. The discount window provides an important safety valve function which enables the Federal Reserve to conduct monetary policy effectively. Member bank attrition means that fewer banks have immediate access to the discount window on a day-to-day basis. As attrition continues, we could reach the point where there would be a significant reduction in the financial system's flexibility in adapting to such things as a tightening of credit policies. The discount window provides individual member banks with a reasonable period of time to make orderly adjustments in their lending and investment policies. This cushion provided by the window facilitates implementation of a restrictive monetary policy in a period of inflationary demands. We have seen this recently when the use of the window has helped make the adjustment to tighter conditions.

The attrition in deposits subject to reserve requirements set by the Federal Reserve also weakens the linkage between bank reserves and the monetary aggregates. As a larger and larger fraction of deposits becomes subject to the diverse reserve requirements set by the 50 States rather than by the Federal Reserve, the relationship between money supply and reserves provided by the Federal Reserve becomes less and less predictable.

Our staff has attempted to assess the extent to which growth in nonmember bank deposits would weaken the relationship between reserves and money. Their tentative results are shown in chart X. Look at that chart for just a moment. It depicts the greater range of short term variability in M_1 and M_2, with a given level of bank reserves, that would develop as the percent of deposits held by nonmembers rises.

If you look at the horizontal axis, you will see that as the percent of bank deposits not subject to reserve requirements goes up, there is a much greater percent of variability in predictability than there would otherwise be. As more and more deposits are held outside the System, the chart suggests that control of money through the reserve base becomes increasingly uncertain.

Finally, it should be pointed out that fewer member banks within the Federal Reserve means that fewer institutions can be influenced by changes in reserve requirements set by the Federal Reserve. Changes in reserve requirements have not been a very active instrument of monetary policy in recent years, as Chairman Reuss pointed out, but this has been in part because of a desire to avoid worsening the membership problem if reserve requirements were raised.

If the membership problem could be resolved, possibly through universal reserve requirements, adjustment in reserve ratios might be made more flexibly when needed to affect bank credit throughout the country or to influence banks' efforts to attract particular types of deposits. Moreover, while open market operations in U.S. Government securities provide the Federal Reserve with a powerful policy instrument, it is possible that conditions could develop in the future—such as a less active market for U.S. Government securities in a period of reduced Federal deficits, which I hope we will see soon—where more flexible adjustments of reserve requirements might be desirable as an adjunct to the window or to the desk in efforts to control the monetary aggregates.

Not only is monetary control made more difficult by membership attrition, but the quality of the banking system is also adversely affected. The Federal Reserve Act authorizes Reserve banks to discount paper for nonmembers, but only under "unusual and exigent" circumstances. By the time such an emergency loan were made, therefore, the bank would have already encountered serious difficulties, and more problems could be expected as it became known that the bank was in an emergency condition. As a member, on the other hand, the bank would probably have begun to borrow from the window under regular procedures and the development of an emergency might be forestalled.

The presence of the Federal Reserve in the bank supervisory and regulatory area—a presence that becomes diluted with membership attrition—also enhances the quality of the banking system. The activities of the System in that area cannot be readily separated from its job of conducting monetary policy. Regulatory and supervisory policies can have important implications for monetary policy and credit flows. Changes in the ceiling rate on time deposits are only the most obvious of such policies; others concern capital adequacy, bank liquidity, international banking, and the quality of loan portfolios.

Attrition of membership, as it continues, also threatens to lead to a deterioration in the quality of the payments mechanism that underlies all of the Nation's economic transactions. Reserve balances held at Federal Reserve banks are the foundation of the payment mechanism because these balances are used for making payments and settling accounts between banks. Nonmember deposits at correspondent banks can serve the same purpose. But as more and more of the deposits used for settlement purposes are held outside the Federal Reserve, the banking system becomes increasingly exposed to the risk that such funds might be immobilized if a large correspondent bank experienced substantial operating difficulties or liquidity problems.

A liquidity crisis affecting a large clearing bank would have widespread damaging effects on the banking system as a whole because smaller banks might become unable to use their balances in the normal course of business. The Federal Reserve, of course, is not subject to liquidity risks and, therefore, serves as Congress intended as a completely safe foundation for the payments mechanism.

These various problems that either cause or result from member bank attrition could be solved in a variety of ways, some of which we have suggested and some of which you have suggested. We believe that the approach the Federal Reserve has suggested is an effective one and is an appropriate one under the circumstances.

First, we have suggested the Universal Reserve Requirements Act of 1978, which Chairman Reuss introduced at our request. It was submitted by the Board for the purpose of reducing the competitive inequality between banks and other institutions insofar as transactions accounts are concerned and to lay the basis for more effective monetary control. Universal reserve requirements can eliminate the competitive inequality by imposing a similar reserve requirements structure on similar institutions. This bill imposes reserve requirements set by the Federal Reserve on transactions balances of all depository institutions. The first $5 million of such balances would be exempt from reserve requirements, although a relatively small requirement could be imposed if it proved necessary in the public interest. This exemption would mean that about one-third of the present member banks and about two-thirds of nonmembers would not be subject to reserve requirements on transactions accounts. This is a limited extension of universal reserves which would significantly reduce the competitive inequality that now exists.

The Board favors universal requirements for reasons quite apart from the membership problem. Universal reserves would contribute to improving monetary management and to insuring the stability of the payments mechanism.

Let me stress that the Board's bill does not authorize any supervisory role for the Federal Reserve with respect to nonmembers. Indeed, the bill does not even require that nonmember institutions establish an account relationship with the Reserve bank. A nonmember's reserves could be held at a correspondent bank—or at a Federal Home Loan bank in the case of savings and loan associations—and merely passed through to the Fed on a 1 to 1 basis by the correspondent. Nonmembers would, however, have to report data on their deposits and certain other items to the local Reserve bank for monetary management purposes.

We realize that universal reserve requirements have been proposed before and that the proposal raises a number of difficult problems. The Board continues to believe, however, that such reserves are necessary to help correct the competitive imbalances in our financial system and to insure an effective monetary policy.

The Board's other proposal is presented separately. I mentioned that the Senate has linked them together in one bill, but they are presented here separately. I recommend this second proposal to you for approval, through passage of H.R. 13477, even if Congress does not enact universal reserve requirements. However, we would suggest that the last sentence of that bill be deleted—and I will mention this again later—the sentence that restricts the payment of interest on certain sizes of balances.

Apart from universal reserves, the Board's proposal has four other major features: One, reduction and restructuring of demand deposit reserve requirements; two, payment of compensation on required reserve balances; three, charges for services provided by Reserve banks; and four, a transfer of a portion of the Federal Reserve surplus to the Treasury during a transition period in order to preserve the Treasury's revenue and thus to avoid any increase in the Federal deficit. The Board's plan is described in some detail in the preliminary proposal that is attached to my testimony, and I believe each of you has a copy.

The reduction in reserve requirements, together with the proposed payment of interest on reserves, would about offset the membership burden as presently measured, after allowing for charges for services to members. The net cost to the Treasury of this program, in the absence of universal reserve requirements, would be about $300 million, based on deposits and reserves in 1977. This figure, of course, takes into account that the reduction in Federal Reserve earnings will be partially recouped by the Treasury from banks, stockholders, and customers who will receive the benefit of this reduced burden in taxable income.

During a 3-year phase-in period, there would be no loss in Treasury revenues, since the System would reimburse the Treasury from its accumulated surplus. After that, the actual loss would be considerably less than the estimated $300 million cost of the Board's plan.

Membership attrition would continue in the absence of a program to resolve the problem. Please look at chart XI: You will see that without this program, by the fourth year, continuing attrition would cost the Treasury an estimated $80 to $210 million a year as a result of the continuing decline in membership and in member bank reserves held at the Fed. The straight lines slanting upward are the ones to follow. The bottom line shows the cost of attrition to the Treasury if the national trend in loss of membership should continue. The upper line shows the cost to the Treasury if attrition were to increase to the rate that has been experienced in New England.

It is my personal view that conditions are such that we could experience an increase in loss of membership such as has already happened in New England. It is my view that the upper line represents the more probable result in the absence of this program. Compare that with the cost of the Board plan—which costs less in its early years and then jumps up once the full plan is in effect—and you will see that there is a close approximation between what our plan would cost given a stabilized situation and what the Treasury would lose anyway if we do not stop attrition.

The Board's proposed Interest on Reserves Act would limit the amount of the interest paid under the Board's plan, after deducting the total amount of charges imposed for services, to no more than 7 percent of the net earnings of the Federal Reserve banks in any 1 year. The purpose of that limitation, as you know, is to give Congress control over the Fed's authority to pay out net earnings.

As you know, last year the earnings of the Federal Reserve were about $6 billion, so a 7 percent limit would give us about $420 million to be used for this purpose.

Within this limitation, the Board proposes to pay close to the market rate of interest on required reserve balances up to $25 million in size. The proposed rate would be one-half percentage point below the average return on the System's portfolio. In 1977, the return on the portfolio was such that the resulting figure would be about 6 percent. On larger balances, the Federal Reserve proposes to pay interest at 2 percent.

The Board's proposal was embodied in H.R. 13477. But that bill also imposes a 2-percent limitation on reserve balances in excess of $25 million. While the Board intends to do that, we do not believe that that kind of limitation should be written into law. We think the 7-percent cap assures Congress of a limitation in interest payments, and we would prefer to have some flexibility in setting the point at which interest rates change. Over the years conditions could change, and we need to be able to adapt as experience is gained.

Now let me turn for a moment to a discussion of the Stanton bill and Chairman Reuss' proposed amendment to it. In the Board's view, the Stanton bill is a constructive approach to dealing with the membership problem. Indeed, by permitting the payment of a market rate of interest on reserve balances, the bill would likely make membership in the System attractive for virtually all banks that are now nonmembers. In the context of this bill, open access to Federal Reserve services could then be provided to all depository institutions without risking any adverse effects of membership. Of course, let me point out that we adjusted our own proposals as to rate of payment of compensation to reduce their cost impact, in the belief that some limitation at this time was necessary.

The Board is concerned, however, that the specific provisions regarding changes for Federal Reserve services in the Stanton bill might be unduly restrictive. For example, the bill requires that the Federal Reserve price take account of capital and other costs that would have been paid by a private firm. However, we believe that any provision requiring the System to charge for services should also recognize the realities of the competitive marketplace and the responsibility of the

System to provide a basic level of service nationwide. I believe this would be in the public interest.

The amendment to the Stanton bill is broad in scope. It seeks major changes in the powers and responsibilities of the Federal Reserve, and would adversely affect the System's ability to carry out its responsibilities. The amendment, if adopted, would not provide a solution to the membership problem; rather, it would make the problem worse. Under the amendment, open access to all System services, except the discount window, would be available to all institutions, and the rate of interest on reserve balances would be limited so that the amount of interest paid would be no greater than the total amount collected by the Federal Reserve in payment for services, plus the small amount of interest earned at the discount window. In consequence, interest payable on reserves would be substantially less than a market rate. Therefore, a bank willing to forego access to the discount window could withdraw from membership and still have access to all Federal Reserve services. Such a bank could then invest the reserve balances released by withdrawal from the System so as to earn a full market rate of interest. If those funds were invested in Government bonds, the Treasury would be paying money to that bank. It seems more sensible to us for the Federal Reserve to pay a lesser amount of money to that bank to keep it in the System. If the proposed amendment were enacted, we would expect the rate of loss of membership to accelerate.

The amendment also proposes legislating specific reserve requirement ratios on demand deposits and tying the discount rate to the Treasury bill rate. Such an action would not be desirable, since it would reduce the policy instruments available to carry out the Nation's monetary policy and effectively limit the System to open market operations for that purpose. The Board continues to believe that effective monetary management requires at least the option of having more than one instrument at hand, and, recommends that the proposed amendment therefore not be enacted.

I mentioned earlier the opportunity to use reserve requirements as a monetary policy instrument if we solve the membership problem; reserve requirement changes may become a more useful instrument once this problem is resolved. In any event, they are needed if action is to be taken that emphasizes credit availability at member banks throughout the country, or if conditions require that open market operations be supplemented in order to attain monetary objectives. Reserve requirement changes can also serve at times as a useful signal of change in the System's policy stance. It also should be noted that the reserve requirement proposals on transactions accounts in the amendment apply to member banks only. This would tend to increase existing inequities because member bank savings accounts subject to automatic transfer would bear a higher reserve requirement—equal to that on demand deposits—than similar accounts at nonmember institutions. That would greatly impact the availability of this new service to consumers which we hope to have in effect November 1.

The discount rate, too, has a useful role to play as a signal of policy. For instance, it can be held back when market rates are rising to suggest a certain caution about future rate developments to the market. The stated reason for tying the discount rate to a market rate is to reduce the possibility of arbitrage profits when the discount rate is below market rates. However, as Congressman Stanton pointed out, the Reserve banks already have careful administrative controls to keep arbitrage opportunities to a minimum. Tying the discount rate to the Treasury bill rate makes the cost of member borrowing dependent in part on Treasury debt management, and the rate could be high or low relative to other opportunities that the bank has for investment. Even if it were desirable to tie the discount rate to market rates, the shifting structure of market rates makes it very difficult to find any single rate that is satisfactory. I suppose, from a personal point of view, I wish we could; it would make my life a little easier, and I would not have to face those tough decisions. The Board believes its flexibility with regard to the discount rate should not be limited, in view of the unpredictability of changing market circumstances and international and domestic economic conditions.

The amendment also would require the Federal Reserve to transfer $575 million of its earned surplus to the Treasury over 2 years. This amount is what we have proposed in our plan, as Chairman Reuss pointed out. However, the proposed amendment does not offset the full burden of membership, so the cost to the Treasury would be less than $575 million. Therefore, if these amendments were adopted, it would not be necessary to transfer $575 million to the Treasury.

Finally, the amendment provides for the collection from nonmember institutions of data needed to control the monetary aggregates. This is very helpful. The reports are to be made through the relevant regulatory agencies. I just want to point out that such data are needed on a timely basis, and it would be useful for us to have the flexibility to work out with the agencies how to handle it, rather than to have this mandated. The intended purpose is proper, but we might need a little more flexibility in working out how to get that data.

Mr. Chairman, ladies and gentlemen—Members of Congress who are here today in attendance—I just want to thank you for the opportunity to present our views on this important matter. The problems with which your committee is dealing this morning are of crucial importance to the long-run viability of the Nation's Central Bank, to the health of the Nation's depository institutions, and, indeed, to the national economy. I know the problems are difficult, and I appreciate your willingness to tackle them. I am confident that if we do work together and consider the issues together, we can find solutions in the public interest.

Thank you very much.

[Chairman Miller's prepared statement, together with the charts referred to throughout his oral presentation and a "Preliminary Proposal" of the Board of Governors of the Federal Reserve System, dated July 6, 1978, follows:]

Proposals on Financial Institution

Reserve Requirements and

Related Issues

Statement by

G. William Miller

Chairman, Board of Governors of the Federal Reserve System

before the

Committee on Banking, Finance and Urban Affairs

House of Representatives

July 27, 1978

32-972 O - 78 - 7

It is a pleasure to testify today on behalf of the Federal Reserve System on the bills before your Committee that would promote competitive equity between member banks and other depository institutions and that would strengthen the nation's financial system by stemming the attrition of banks from the Federal Reserve. We are grateful to this Committee and to its distinguished Chairman for considering the proposed legislation so late in the session.

Attrition of membership in the Federal Reserve System is occurring because member banks are at a serious competitive disadvantage relative to other depository institutions. This attrition, as it continues, dilutes the effectiveness with which the Federal Reserve can fulfill its monetary and other objectives. Therefore, I should like, first, to discuss the dimensions and effects of the decline in membership, and then to offer comments on the specific legislation you are considering.

. . MEMBERSHIP IN THE SYSTEM CONTINUES TO DECLINE

The problem facing us is the continuing decline in System membership in recent years. Over the past 8 years 430 member banks have withdrawn from the System, while only 103 nonmember banks have joined, as is illustrated in Chart I. In 1977 69 banks chose to give up their membership, and 39 more banks withdrew in the first half of 1978. This last statistic probably understates the trend, because many member banks appear to be delaying their plans for withdrawal from membership until they see what action the System takes to resolve the membership problem. Most of the banks withdrawing from membership have been small, with total deposits under

$50 million. But a disturbing tendency has developed recently for larger banks also to leave the System, as shown by comparing the top and bottom panels of Chart II. Fifteen of the sixty-nine banks leaving the System in 1977 had deposits of more than $100 million, a record number for that size of bank.

The steady downward trend in the number of member banks has been accompanied, of course, by a decline in the proportion of bank deposits subject to Federal Reserve reserve requirements, as may be seen from Chart III. As of the end of 1977, member banks held less than 73 per cent of total commercial bank deposits, down about 8 percentage points in the last 8 years. Thus, more than one-fourth of commercial bank deposits--and over three-fifths of all banks--are outside the Federal Reserve System.

In New England, where the development of NOW accounts in the past 5 years has greatly sharpened competition among depository institutions, the decline in membership and in deposits held by member banks has been even more dramatic, as illustrated in Chart IV. The share of deposits in New England held by member banks fell by 11 percentage points in the last three years alone--from 73 per cent at the end of 1974 to less than 62 per cent at the end of 1977.

. . DUE TO THE EXCESSIVE COST OF MEMBERSHIP

The basic reason for the decline in membership is the financial burden that membership entails. Most nonmember banks and thrift institutions may hold their required reserves in the form of earning assets or in the form of deposits (such as correspondent balances) that would be held in the normal course of business.

Member banks, by contrast, must keep their required reserves entirely in non-earning form. In consequence, as may be seen in Chart V, member banks hold a greater percentage of their total assets in non-earning form than do nonmembers.

The cost burden of Federal Reserve membership thus consists of the earnings that member banks must forego because of the extra amount of non-earning assets that they are required to hold. Of course, member banks are provided with services by Federal Reserve Banks, but the value of these services does not by any means close the earnings gap between member and nonmember banks. And, as a result, the earnings rate for member banks runs persistently below that for non-members, as illustrated in Chart VI.

The Board staff estimates that the aggregate cost burden to member banks of Federal Reserve membership may exceed $650 million annually, based on data for the year ending in September 1977, or about 9 per cent of member bank profits before income tax. The burden of membership is not distributed equally across all sizes of member banks. According to our estimates, shown in the lower panel of Chart VII, the relative burden is greatest for small banks--exceeding 20 per cent of profits for banks with less than $10 million in deposits.

. . INEQUITY OF COST BURDEN BORNE BY MEMBER BANKS

The competitive inequality caused by sterile reserve balances can be regarded as an additional "tax" levied upon member banks. This "tax" produces Federal Reserve earnings that are paid over to the Treasury and thereby become additional revenue to the U.S. Government.

But this "tax" is inherently unfair because it falls only on member banks. Nonmember banks and thrift institutions, both of which compete with members in many of the same markets for deposits and loans, do not bear this tax.

Member banks naturally attempt to minimize the added burden of sterile reserves that they bear, but there are practical limitations on their ability to do so. Those banks most successful in taking such steps are the very largest banks. Because of their size, character of their business, and managerial resources, these banks have access to sources of funds or to activities--such as participation in international banking, making repurchase agreements with business corporations, and borrowing Federal funds--that are either free of reserve requirements or involve relatively small reserve requirements. Moreover, such banks are usually large correspondents that provide services to smaller banks, including those based on access to Federal Reserve facilities.

Furthermore, requiring sterile reserves only from member banks is an inefficient way to raise revenue for the Treasury, because it leads to withdrawals from the System, resulting in reduction in Treasury revenues. For example, withdrawals since 1970 have reduced Federal Reserve earnings in 1977 by nearly $220 million from what they would have otherwise been, as shown in Chart VIII, and have reduced net Treasury revenues by about $100 million.

. . INCREASED COMPETITION FOR DEPOSITS HEIGHTENS AWARENESS OF BURDEN

It is obvious from the continuing erosion in Federal Reserve membership that more and more banks are becoming acutely aware of the cost burden of membership and of the competitive handicap arising from that burden. The cost of membership is due in part to the high interest rates induced by inflation in recent years. With market interest rates exceeding 5 per cent for much of the past decade, the earning opportunities foregone by holding required reserves at Reserve Banks have become painfully clear to member banks.

At the same time, competitive pressures on banks have increased. Banks once had a virtual monopoly on transactions accounts because of their ability to offer demand deposits. But this unique position is being eroded. Financial innovations have led to widespread use of interest-bearing accounts at nonbank depository institutions as well as banks for transactions purposes. Since 1970, these innovations have included the following: limited pre-authorized "bill-payer" transfers from savings accounts at banks and savings and loan associations, NOW accounts at practically all depository institutions in New England, credit union share drafts, telephone transfers from savings deposits, and the use of electronic terminals to make immediate transfers to and from savings accounts. Growth of these transactions-related interest-bearing deposits has been most dramatic in recent years. For example, NOW accounts have grown from almost zero in 1974 to nearly 8 per cent of household deposit balances in New England in 1977, as shown in Chart IX.

There is no sign that the intense competition for transactions accounts will abate. These heightened competitive forces are compelling all depository institutions to be more cost sensitive and to seek ways to maintain their profitability. Experience shows that withdrawal from the Federal Reserve System is a strategy that many bank managements have chosen in these circumstances.

. . REDUCED MEMBERSHIP IN THE FEDERAL RESERVE WEAKENS THE FINANCIAL SYSTEM

The declining trend in membership is of great concern because, as it continues, it will inevitably weaken our financial system in a number of ways.

Declining membership threatens to alter the character of the Federal Reserve System as an institution away from that which Congress originally intended. Congress intended the nation's central bank to provide needed liquidity and to establish an efficient national payments system, among other purposes. All commercial banks were made eligible to participate in the governance and the services of the regional Reserve Banks. Membership in the System was not restricted to national banks alone, because the System's designers considered broad representation from all classes of banks located in every region of the nation to be essential to the System's functioning in the public interest. They especially wished to avoid over-representation by the largest banks. Moreover, in founding the System, Congress hoped State-chartered banks would join in order to strengthen both the System and the ability of the State banks to serve their communities.

These purposes are as valid today as they were 65 years ago, but continued attrition of membership could defeat these Congressional goals. If current trends continue, membership in the Federal Reserve will consist predominantly of the very largest banks and of the smaller national banks who might choose, for one reason or another, not to convert to state charters. The monetary and other policies of the Federal Reserve would then have their most immediate impact on a relatively small part of our financial system.

. . MONETARY MANAGEMENT WEAKENED

As fewer and fewer banks, and a smaller share of the nation's deposits, remain with the Federal Reserve System, the ability of the System to influence the nation's money and credit becomes weaker. The discount window provides an important safety-valve function, which enables the Federal Reserve to conduct monetary policy effectively. Member bank attrition means that fewer banks have immediate access to the discount window on a day-to-day basis. As attrition continues, we could reach the point where there would be a significant reduction in the financial system's flexibility in adapting to, for example, a tightening of credit policies. The discount window provides individual member banks with a reasonable period of time to make orderly adjustments in their lending and investment policies. The cushion provided by the window facilitates implementation of a restrictive monetary policy in a period of inflationary demands.

The attrition in deposits subject to reserve requirements set by the Federal Reserve also weakens the linkage between bank reserves and the monetary aggregates. As a larger and larger fraction of deposits becomes subject to the diverse reserve requirements set by the 50 states rather than by the Federal Reserve, the relationship between money supply and reserves provided by the Federal Reserve becomes less and less predictable.

Our staff has attempted to assess the extent to which growth in nonmember bank deposits would weaken the relationship between reserves and money. Their tentative results are shown in Chart X, which depicts the greater range of short-run variability in M-1 and M-2, with a given level of bank reserves, that would develop as the per cent of deposits held by nonmembers rises. As more and more deposits are held outside the System, this chart suggests that control of money through the reserve base becomes increasingly uncertain.

Finally, it should be pointed out that fewer banks within the Federal Reserve means that fewer institutions can be influenced by changes in reserve requirements set by the Federal Reserve. Changes in reserve requirements have not been a very active instrument of monetary policy in recent years, but this was in part because of a desire to avoid worsening the membership problem if reserve requirements were to be raised. If the membership problem could be resolved, possibly through universal reserve requirements, adjustments in reserve ratios might be made more flexibly when needed to affect bank credit throughout the country, or to influence banks' efforts to attract particular types of deposits. Moreover, while open market operations in U.S. Government securities provide the Federal Reserve with a powerful policy instrument, it is possible that conditions could develop in the future--such as a less active market for U.S. Government securities in a period of reduced Federal budgetary deficits--where more flexible adjustment of reserve requirements might be a desirable adjunct in efforts to control the monetary aggregates.

. . ADVERSE IMPACTS ON QUALITY OF BANKING SYSTEM

Not only is monetary control made more difficult by membership attrition, but the quality of the banking system is also adversely affected. The Federal Reserve Act authorizes Reserve Banks to discount paper for nonmembers, but only under "unusual and exigent" circumstances. By the time such an emergency loan were made, therefore, the bank would have encountered serious difficulties, and more problems could be expected as it became known that it was in an "emergency" condition. As a member, on the other hand, the bank would have probably begun to borrow under regular procedures, and the development of an emergency might have been forestalled.

The presence of the Federal Reserve in the bank supervisory and regulatory area--a presence that becomes diluted with membership attrition--also enhances the quality of the banking system. The activities of the System in that area cannot be readily separated from its job of conducting monetary policy. Regulatory and supervisory policies can have important implications for monetary policy and credit flows. Changes in the ceiling rate on time deposits are only the most obvious of such policies; others concern capital adequacy, bank liquidity, international banking, and the quality of loan portfolios.

. . POTENTIAL DETERIORATION IN THE PAYMENTS SYSTEM

Attrition of membership, as it continues, also threatens to lead to a deterioration in the quality of the payments mechanism that underlies all of the nation's economic transactions. Reserve balances held at Federal Reserve Banks are the foundation of the payments mechanism, because these balances are used for making payments and settling accounts between banks. Nonmember deposits at correspondent banks can serve the same purpose, but as more and more of the deposits used for settlement purposes are held outside the Federal Reserve, the banking system becomes increasingly exposed to the risk that such funds might be immobilized if a large correspondent bank experienced substantial operating difficulties or liquidity problems. A liquidity crisis affecting a large clearing bank would have widespread damaging effects on the banking system as a whole because smaller banks might become unable to use their clearing balances in the ordinary course of business. The Federal Reserve, of course, is not subject to liquidity risk and therefore serves, as Congress intended, as a completely safe foundation for the payments mechanism.

These various problems that either cause or result from member bank attrition could be solved in a variety of ways, and a number of bills are before you. We believe our approach is the most effective one under existing circumstances.

. . UNIVERSAL RESERVE REQUIREMENTS

The Universal Reserve Requirements Act of 1978, introduced as H.R. 13476, was submitted by the Board to reduce competitive inequality between banks and other institutions insofar as transactions accounts are concerned and to lay the basis for more effective monetary control. Universal reserve requirements can eliminate the competitive inequality by imposing a similar reserve requirements structure on similar institutions. H.R. 13476 imposes reserve requirements set by the Federal Reserve on transactions balances at all depository institutions. The first $5 million of such balances would be exempt from reserve requirements, although a relatively small requirement could be imposed if it proved necessary in the public interest. This exemption would mean that about one-third of present member banks and about two-thirds of nonmembers would not be subject to reserve requirements on transactions accounts. This limited extension of universal reserves would significantly reduce competitive inequality.

The Board favors universal reserve requirements for reasons quite apart from the membership problem. Universal reserves would contribute to improving monetary management and to ensuring the stability of the payments mechanism. In doing so, the Board's bill, it should be stressed, does not authorize any supervisory role for the Federal Reserve System with respect to nonmembers. Indeed, the bill does not even require nonmember institutions to establish an account relationship with the Reserve Bank. A nonmember's reserves can be held at a correspondent bank--or at a Federal Home Loan Bank, in the case of savings and loan associations--and merely passed through to the Fed on a one-to-one basis by the correspondent. Nonmembers would, however, have to report data on their deposits and certain other items to the local Reserve Bank for monetary management purposes.

We realize that universal reserve requirements have been proposed before, and that the proposal raises a number of difficult problems. The Board continues to believe, however, that they are necessary to help correct the competitive imbalances in our financial system and to assure an effective monetary policy.

. . OTHER PROGRAM ELEMENTS

The Board's other proposal is presented separately and is recommended for prompt Congressional approval through passage of H.R. 13477, even if Congress does not enact universal reserve requirements in this session. However--for reasons discussed later--the Board urges deletion of the last sentence of that legislation, which imposes a limitation of 2 per cent on required reserve balances in excess of $25 million.

Apart from universal reserves, the Board's proposal has four other major features: reduction and restructuring of demand deposit reserve requirements, payment of compensation on required reserve balances, charges for services provided by Reserve Banks (along with slightly broadened access to those services), and transfer of a portion of System surplus to the Treasury during the transition period in order to preserve the Treasury's revenue position while the plan is implemented. All of the provisions of the Board's plan are described in some detail in the "Preliminary Proposal" that is attached to this testimony, and which we would appreciate having made part of the record of these hearings.

The reduction in reserve requirements, together with the proposed payment of interest on reserves, would about offset the membership burden as presently measured, after allowing for charges for services to members. The net annual cost to the Treasury of this program, in the absence of universal reserve requirements, would be about $300 million, based on deposits and reserves in 1977. This figure, of course, assumes that part of the reduction in Federal Reserve earnings is recouped by the Treasury from banks, their stockholders, and customers in the form of taxes on increased earnings and capital gains.

During a three-year phase-in period for the program, there would be no loss in Treasury revenues, since the System would reimburse the Treasury from its accumulated surplus. After that period, the actual loss would be considerably less than the estimated $300 million cost of the Board's plan. Membership attrition would continue in the absence of a program to resolve the problem. As shown in chart XI, without the program, by the fourth year continued attrition probably would be costing the Treasury between $80 and $210 million as a result of further declines in member bank reserves held at the Federal Reserve. Thus, the true cost of the program is considerably lower than $300 million. Moreover, should the program increase membership, the cost would be reduced even further.

. . INTEREST ON RESERVES ACT

The Board's proposed Interest on Reserves Act of 1978 would limit the amount of interest paid under the Board's plan, after deducting the total amount of charges imposed for services, to no more than 7 per cent of net earnings of the Federal Reserve Banks in any one year. (During 1977, net earnings were about $6 billion.) Within this limitation, the Board proposes to pay close to a market rate of interest on required reserve balances up to $25 million in size. The proposed rate would be ½ percentage point below the average return on the System's portfolio; in 1977, the return on portfolio would have permitted a 6 per cent rate on such reserve balances. Larger balances would earn interest at a 2 per cent rate.

The Board's proposal was embodied in H.R. 13477, but that bill also imposes a 2 per cent limitation on reserve balances in excess of $25 million. The Board does not believe that the 2 per cent limitation should be written into law. H.R. 13477 in any event contains an over-all percentage limitation on the amount of interest payments the Federal Reserve can make, and it is essential to retain administrative flexibility in setting interest rates within the over-all limitation, so that adjustments can be made as circumstances change and experience is gained.

. . LEGISLATIVE PROPOSALS ADVANCED BY OTHERS

The remainder of my testimony will discuss the Stanton Bill and Chairman Reuss' proposed amendment to it.

In the Board's view, H.R. 12706, the Stanton Bill, is a constructive approach to dealing with the membership problem. Indeed, by permitting payment of a market rate of interest on reserve balances, the bill would likely make membership in the System attractive to virtually all banks that are now nonmembers. In the context of this bill, open access to Federal Reserve services could then be provided to all depository institutions without risking adverse effects on membership.

The Board is concerned, however, that the specific provisions regarding charges for Federal Reserve services in H.R. 12706 may be unduly restrictive. For example, the bill requires that the Federal Reserve price to take account of capital and other costs that would have been paid by a private firm. However, we believe that any provision requiring the System to charge for services should also recognize the realities of the competitive marketplace and the responsibility of the System to provide a basic level of service nationwide.

The proposed amendment to the Stanton bill is broad in scope, seeks major changes in the powers and responsibilities of the Federal Reserve, and would adversely affect the System's ability to carry out its responsibilities. Moreover, the amendment, if adopted, would not provide a solution to the membership problem; rather, it would make the problem much worse. Under the amendment, open access to all System services (except the discount window) would be available to all institutions, and the rate of interest on reserve balances would be limited so that the amount of interest paid could be no greater than the total amount collected by the Federal Reserve in payment for services plus the small amount of interest earned at the discount window. In consequence, interest payable on reserves would be substantially less than a market rate. Therefore, a bank willing to forego access to the discount window could withdraw from membership and still have access to all Federal Reserve operating services, while also investing the reserve balances released by withdrawal from the System so as to earn a full market rate of interest. If the proposed amendment were enacted, we would expect the rate of loss of membership to accelerate.

The amendment also proposes legislating specific reserve requirement ratios on demand deposits and tying the discount rate to the Treasury bill rate. Such an action would not be desirable since it would reduce the policy instruments available to carry out the nation's monetary policy and effectively limit the System to open market operations for that purpose. The Board continues to believe that effective monetary management requires the option of having more than one instrument at hand, and thus recommends that the proposed amendment not be enacted.

As noted earlier, reserve requirement changes may become a more useful instrument once the membership problem is resolved. In any event, they are needed if action is to be taken that emphasizes credit availability at member banks throughout the country or if conditions require that open market operations be supplemented in order to attain monetary policy objectives. Moreover, reserve requirements changes can also serve, at times, as a useful signal of change in the System's policy stance. It also should be noted that the reserve requirement proposals on transactions accounts in the amendment apply to member banks only. This would tend to increase existing inequities because member bank savings accounts subject to automatic transfer would bear a higher reserve requirement--equal to that on demand deposits--than similar accounts at nonmember institutions.

The discount rate, too, has a useful role to play as a signal of policy. For instance, it can be held back when market rates are rising to suggest a certain caution about future rate developments to the market. The stated reason for tying the discount rate to a market rate is to reduce the possibility of arbitrage profits when the discount rate is below market rates. However, the Reserve Banks already have careful administrative controls that keep arbitrage opportunities to a minimum. Moreover, tying the discount rate to the Treasury bill rate makes the cost of member borrowing depend in part on Treasury debt management, and the rate could be high or low relative to other opportunities the bank has for investment. Even if it were desirable to tie the discount rate to a market rate, the shifting structure of market rates makes it very difficult to find any single rate that is satisfactory. In any

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event, the Board believes its flexibility with regard to the discount rate should not be limited in view of the unpredictability of changing market circumstances and international and domestic economic conditions.

The amendment also would require the Federal Reserve to transfer $575 million of its earned surplus to the Treasury over two years. This amount appears in the Board's plan. But the program in the Reuss amendment, since it does not offset the membership burden, would be less costly than the Board's plan. Therefore, the amount needed to maintain Treasury revenues in a transition period would be less than the $575 million required by the proposed amendment. In any event, the Board does not believe a specific transfer of Federal Reserve surplus should be legislated, but should be left to the Board and the Treasury, since the effect on Treasury revenues will depend on the particular plan chosen and the period of time over which it is practical to implement it fully.

Finally, the amendment provides for the collection from nonmember institutions of data needed to control the monetary aggregates. The reports are to be made through the relevant regulatory agencies. It is important to note, however, that such data are needed on a timely basis if they are to be useful for monetary policy operations. The amendment should, therefore, allow flexibility in handling the flow of data, as might be worked out by the agencies.

Mr. Chairman, thank you for the opportunity to present the Federal Reserve's views this morning. The problems with which your Committee is dealing this morning are of crucial importance to the long-run viability of the nation's central bank and to the health of the nation's depository institutions and indeed to the national economy. The problems are exceedingly difficult, but I am confident we can together find solutions that will serve the public interest well.

Chart I

Voluntary Changes in Federal Reserve Membership

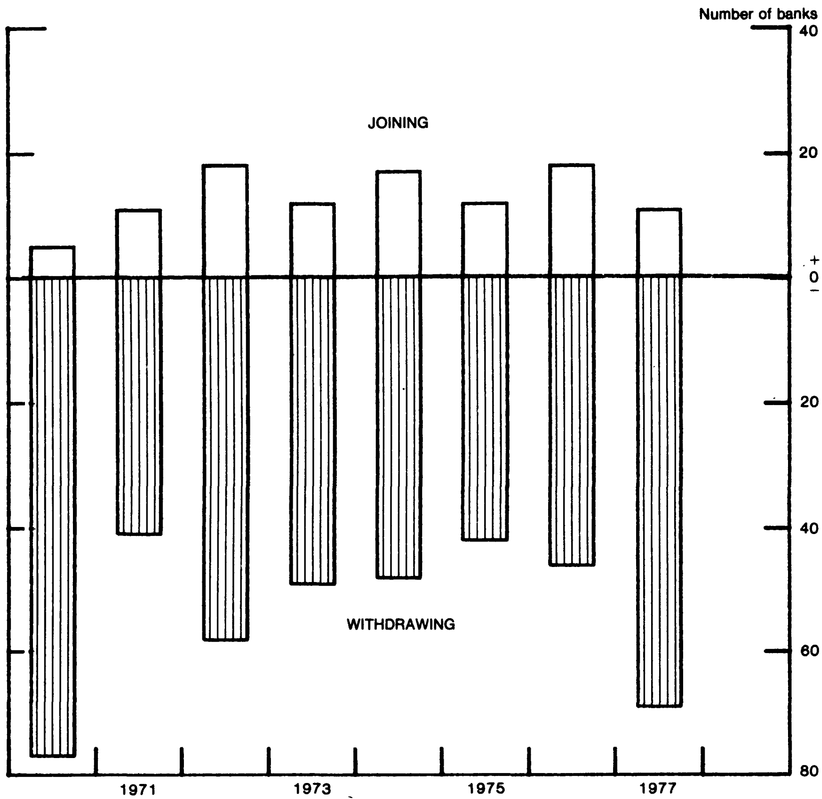


Chart II

Percentage of Banks Withdrawing from the Federal Reserve System

By Size of Bank

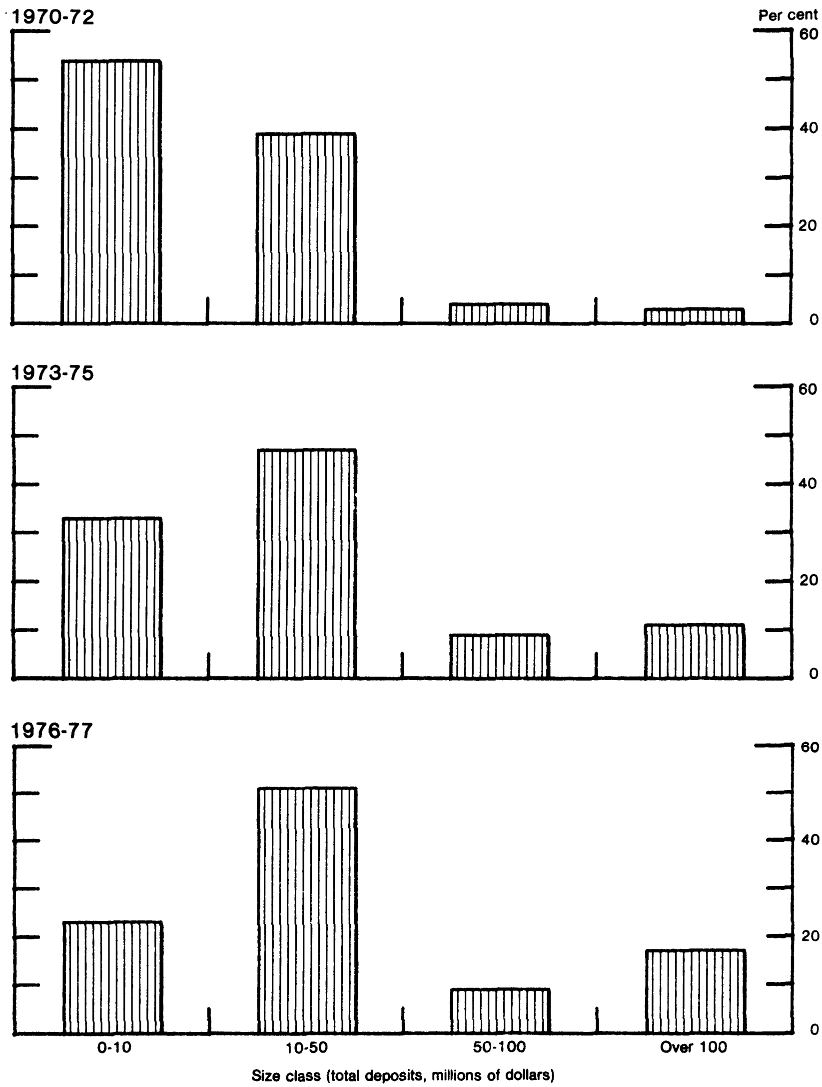


Chart III

Percentage of U.S. Commercial Banks and Deposits in the Federal Reserve System

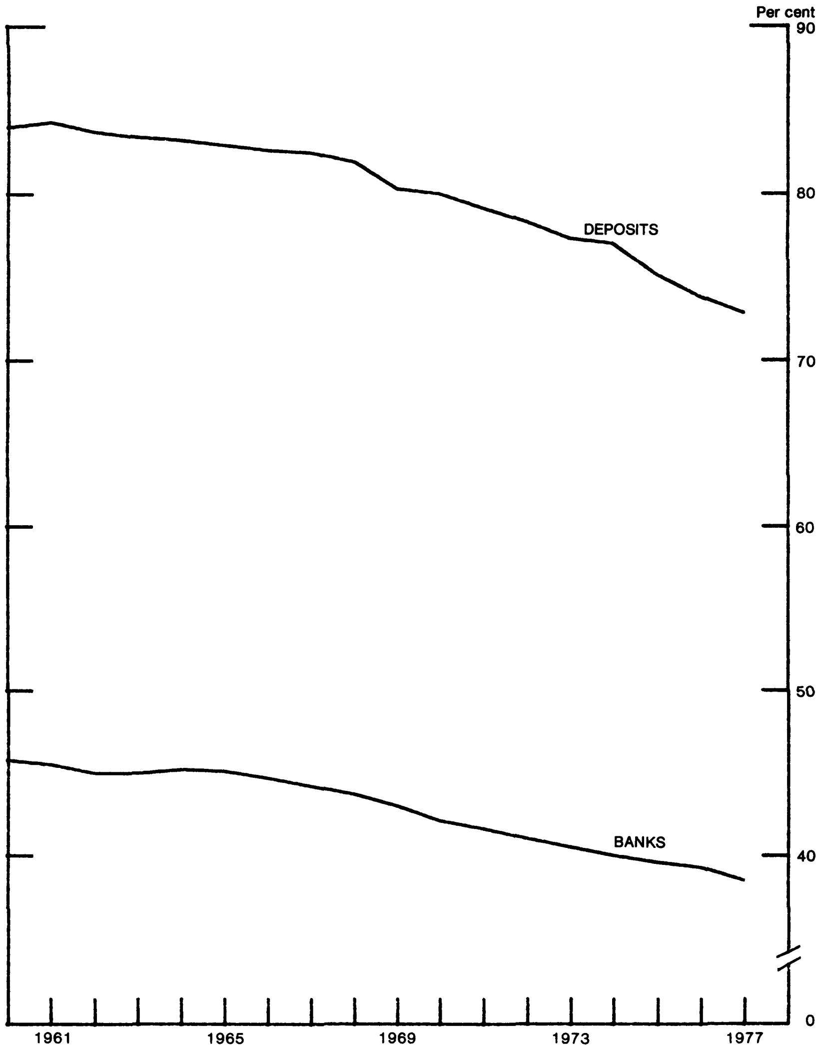


Chart IV

Percentage of New England Commercial Banks and Deposits in the Federal Reserve System

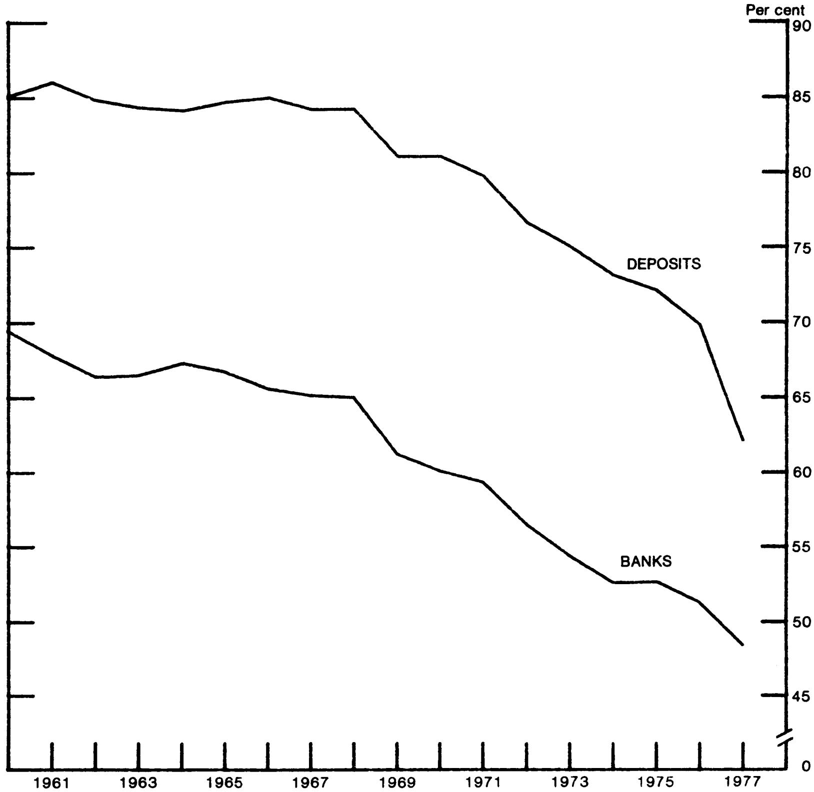


Chart V

Relative Cash Asset Positions of Member and Nonmember Banks

Average Ratio of Cash Assets to Total Assets

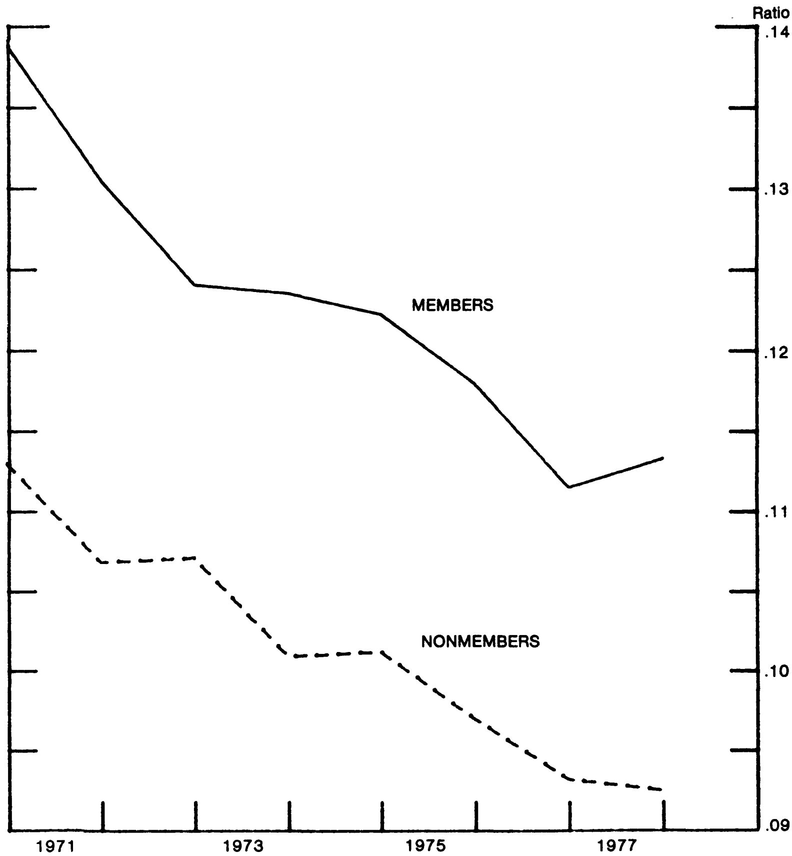


Chart VI

Profitability of Member and Nonmember Banks

Pre-Tax Profits as a Per Cent of Total Assets

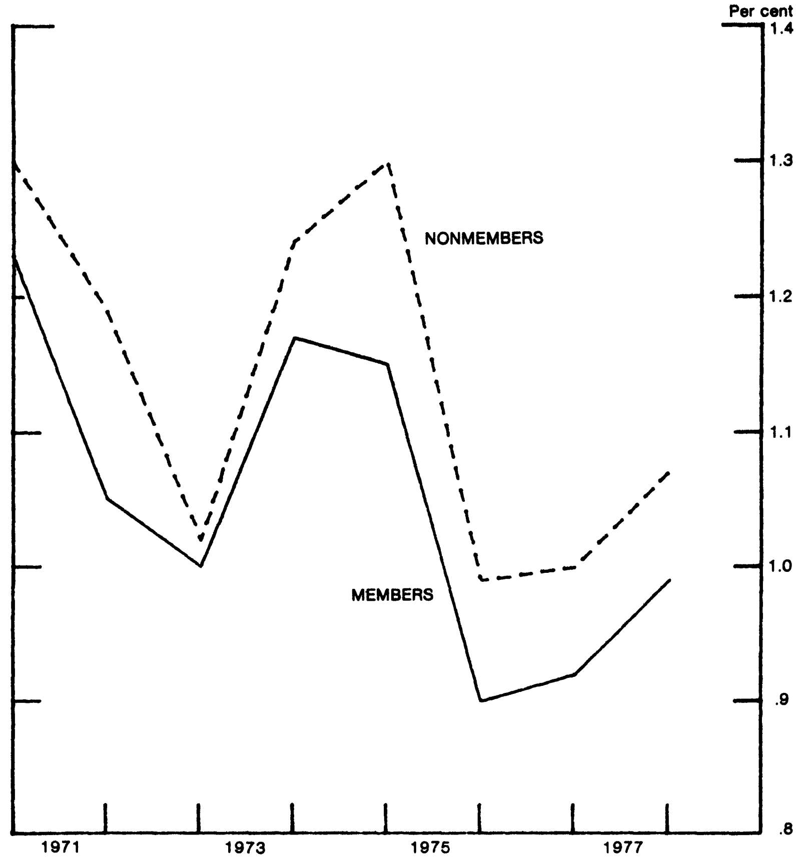
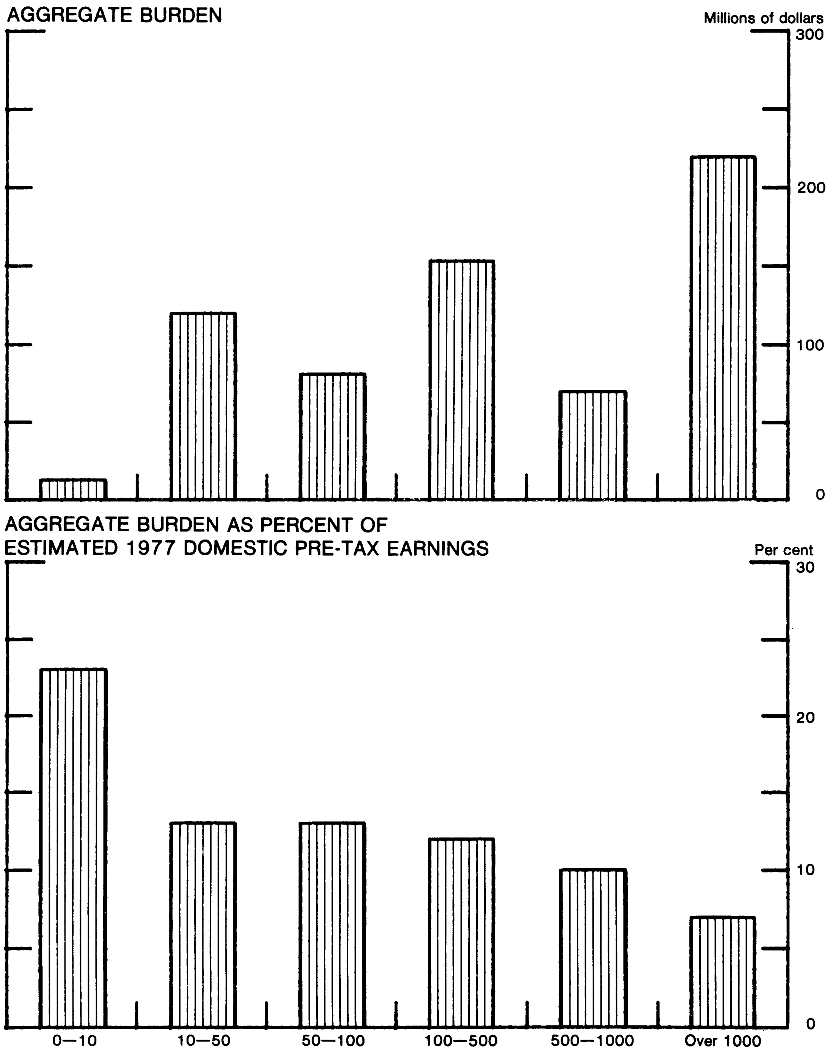


Chart VII

Estimated Burden of Federal Reserve Membership



Bank size class(total deposits, millions of dollars)

Chart VIII

Annual Loss of Federal Reserve Revenues
Due to Attrition Occurring Since 1970

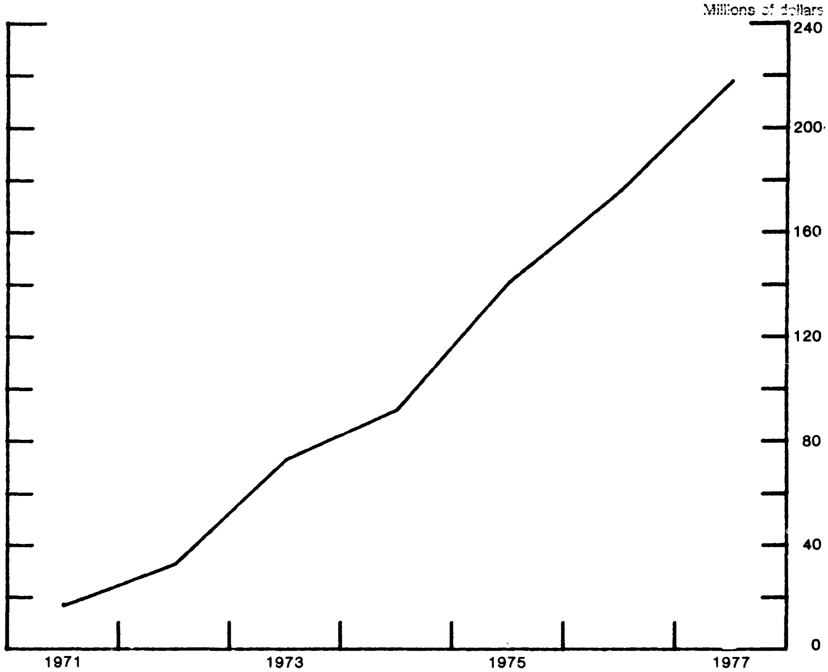


Chart IX

NOW Accounts as Percentage of Household Deposit Balances in New England

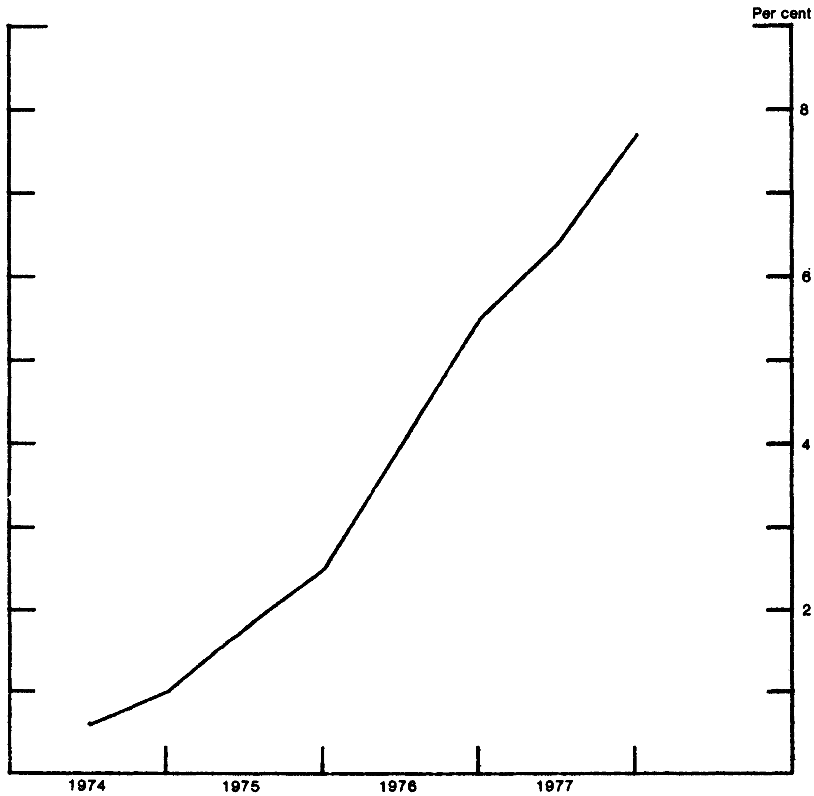
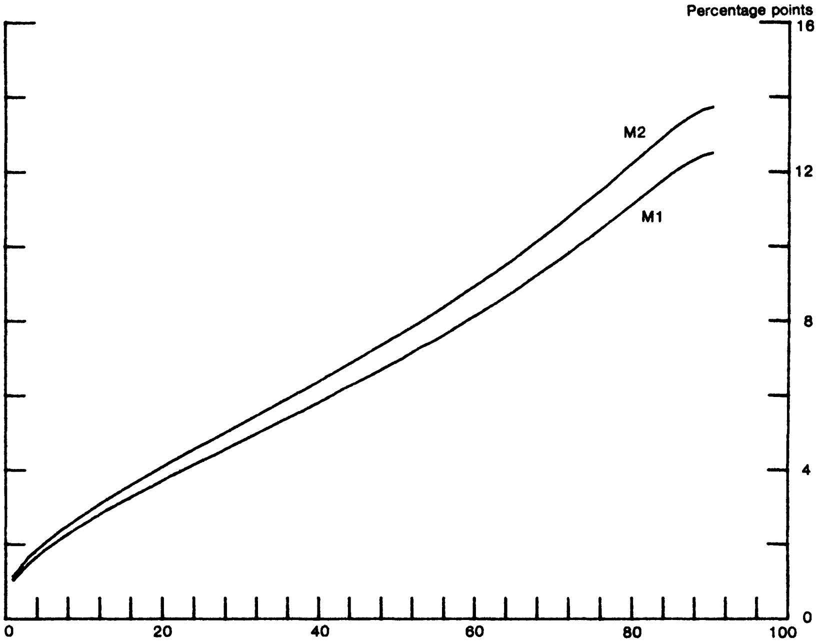


Chart X

Effect of Member Bank Attrition On Short-Run Predictability of Monetary Aggregates

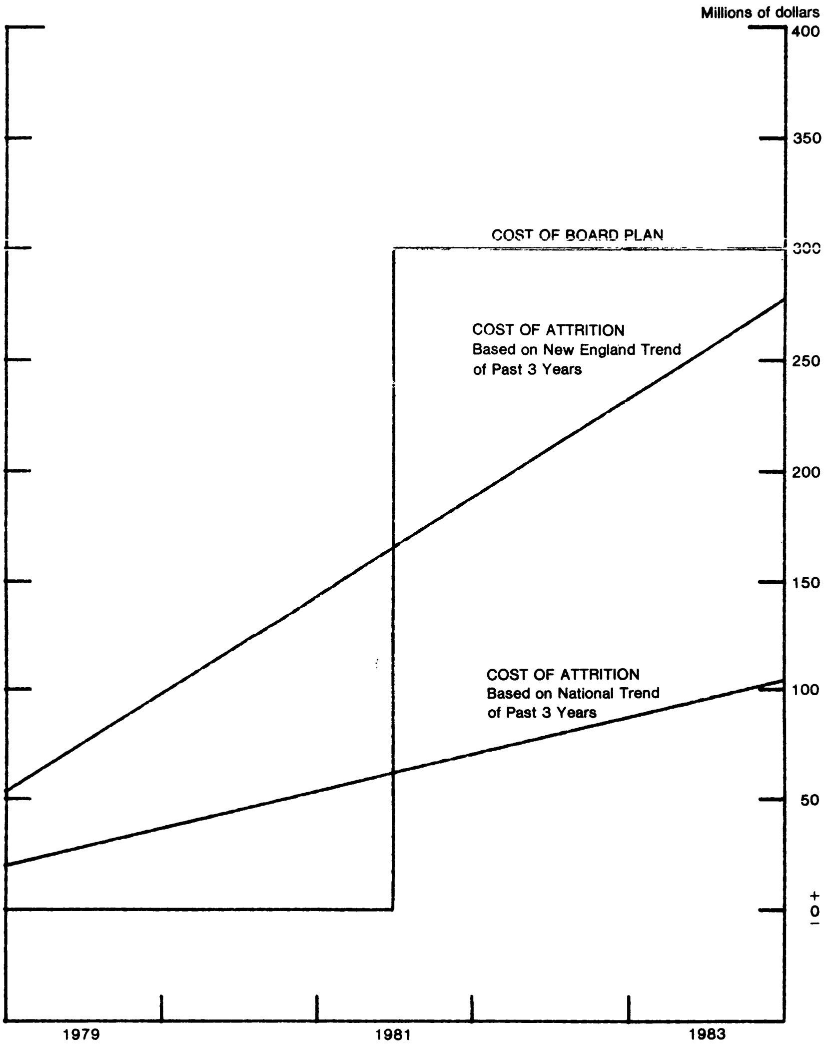
Range of Unpredictable Variability



Per cent of Bank Deposits Not Subject to Reserve Requirements

Chart XI

Estimated Loss of Treasury Revenues, Net of Taxes



7/6/78

BOARD OF GOVERNORS OF THE
FEDERAL RESERVE SYSTEM

PRELIMINARY PROPOSAL

To Promote Competitive Equality Among
Member Banks and Other Financial Institutions
and to Encourage Membership in the Federal Reserve System

The continuing decline of bank membership in the Federal Reserve System and the increasing competition between banks and other depository institutions in providing payments services require prompt, responsive measures.

This preliminary proposal is intended as a means of submitting a program for consideration and appropriate action by Congress.

Background of the Problem

Section 19 of the Federal Reserve Act provides that member banks of the Federal Reserve System are required to maintain reserves against their demand and time deposits in such ratios as shall be determined by the Board within specified legal ranges. In order to satisfy these reserve requirements, member banks are required to maintain reserves in the form of vault cash and balances held in Federal Reserve Banks. Such balances maintained by member banks do not earn any interest at present. By contrast, most banks that are not members of the Federal Reserve System are permitted by State law to hold a substantial part of their required reserves in the form of earning assets, such as United States Treasury obligations, or in the form of balances that would be held in the ordinary course of business in any event. Consequently, member banks incur a burden in the form of foregone earnings on their required reserve balances.

As a result of the inflation of recent years and the increased competition between banks and other depository institutions in providing payments services, more and more banks have become aware of the burden of membership and have determined that the benefits associated with remaining a member bank do not outweigh the costs. Over the past ten years, a total of 551 banks have withdrawn from membership. Although many of the banks that have left the System are small, there is a growing trend among larger member banks to become nonmembers. Of the 69 banks that left the Federal Reserve in 1977, 15 banks possessed deposits in excess of $100 million. Because of the decline in membership, the proportion of total commercial bank deposits held by member banks has by now been reduced to about 72 per cent.

If corrective action is not taken, a continued, probably an accelerated, erosion of membership and of deposits subject to regulation by the Federal Reserve can be expected. This 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 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.

Proposed Legislation for Universal Reserve Requirements

In order to promote fair competition among member banks and other depository institutions and to stem the decline in deposits subject to reserve requirements of the Federal Reserve, the Board will transmit to Congress proposed legislation that would require all depository institutions to maintain reserves against transactions accounts in accordance with requirements set by the Federal Reserve. If uniform, universal reserve requirements on transactions balances become effective, competition among banks and other depository institutions would be on a more nearly equal basis.

The Board's proposed legislation would make transactions accounts--such as demand deposits and NOW (negotiable order of withdrawal) accounts--at all Federally insured depository institutions subject to reserve requirements set by the Federal Reserve. However, a total of $5 million of transactions accounts at these institutions, whether members or nonmembers of the Federal Reserve, would not be subject to the basic reserve requirements. The proposed legislation also adjusts the existing 3 to 10 per cent statutory range for reserve ratios on time and savings deposits at member banks. A reduction in the range to 1/2 of 1 to 10 per cent is proposed for time and savings deposits other than transactions accounts to provide needed flexibility that would enable member banks to compete in this area on a more nearly equal basis with other depository institutions.

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The Board simultaneously is considering a program, described below, whereby the Federal Reserve would charge for certain of its services and would pay some compensation for required reserve balances. However, if Congress enacts a requirement for universal reserves, the Board would need to reconsider whether, and to what extent, its proposed program of service charges and reserve compensation might need to be adjusted in light of the effects of such legislation on Federal Reserve membership, operation of the payments system, and monetary control.

Proposed Federal Reserve Program

In view of the increasingly acute problems associated with the decline in membership in the Federal Reserve System that is attributable to the burden imposed on member banks by competitive inequality, the Board is also considering a program with the following principal elements: (1) restructuring and reduction of demand deposit reserve requirements, (2) charging for services provided by the Federal Reserve, (3) compensating for required reserve balances held at Federal Reserve Banks, and (4) transferring part of Federal Reserve surplus to Treasury during a transition period to offset any Treasury revenue loss.

The program would provide time for Congress to consider the issue of payment of interest on required reserve balances. If the Federal Reserve is not able to pay interest on reserves, or otherwise remove the burden of membership, it would not be feasible to charge for services offered by Federal Reserve Banks. A portion of reserve balances held by member banks with Federal Reserve Banks in effect represents payment for these services under current circumstances. Charging for the services, without compensating banks for the reserves held, would simply increase the burden of membership and exacerbate competitive inequality.

Reserve Requirement Actions. Under the proposed program, the Board would amend Regulation D (Reserves of Member Banks) to simplify the structure of reserve requirements. The proposal would also redefine a reserve city and impose reserve city reserve requirements on member banks with net demand deposits in excess of $600 million (compared to $400 million at present). The structure of reserve requirements would be revised in two phases as follows:

Present		Proposed			
		First phase		Second phase	
Size Class ($ million)	Reserve Requirement	Size Class ($ million)	Reserve Requirement	Size Class ($ million)	Reserve Requirement
0-2	7%	0-10	7%	0-200	7%
2-10	9½%	10-200	9½%	200-600	10%
10-100	11¾%	200-600	12½%	over 600	16½%
100-400	12¾%	over 600	16½%		
over 400	16½%				

It is anticipated that these actions would have the effect of releasing approximately $5 billion in reserves on an annual basis, with about $2½ billion released by the initial adjustment.

Charges for Federal Reserve Services. The second element in the program relates to charging for services rendered by the Federal Reserve. The Federal Reserve does not now generally charge member banks for services it renders in view of the substantial burden of membership presently incurred by banks. Member banks "pay" for Federal Reserve services through the maintenance of reserve balances with Reserve Banks. Nonmember banks are now permitted to use a limited number of Federal Reserve services at no charge.

Competitive equity between member banks and nonmember institutions requires that all users of Federal Reserve services be subject to charges established on the same basis. Moreover, such charges might encourage more efficient use of check clearing facilities and provide incentives for innovations that reduce costs. With explicit pricing, therefore, the opportunities of the private sector to compete with and improve upon Federal Reserve services would be enhanced.

In order to assure continued efficient functioning of the payments mechanism and to avoid major disruption during the transition to a more competitive environment, the Board would follow a conservative and flexible approach in establishing charges for Federal Reserve services. To this end, the System has concluded that its charges should be competitive with those for comparable services (when available) in the private sector. However, the Board would retain flexibility to alter charges or service policies in order to meet its responsibilities to maintain a satisfactory, basic level of service for the nation as a whole and to encourage innovations.

The Board would use the following general principles as guidelines for establishing a price structure:

1. Each Federal Reserve service category for which charges are to be assessed would usually have separate prices by geographic area, activity, and class of work processed. The price schedule would employ explicit per item charges and be as simple as possible. Prices would be adjusted as the System gained experience with service charges and observed their effects in the markets in which the System operates.
2. The System does not contemplate significant alterations in services provided at the time charges initially are imposed. However, after charges are in place, some offices might find it necessary to revise their operating policies and prices to maintain competitiveness and to enable the System to maintain a basic level of service nationwide.
3. All users in the same pricing zone (typically a Federal Reserve Bank, Branch or office area) would pay the same price for a given service. However, identical services might not be provided in all areas.

More specifically, guidelines established by the Board for the pricing of Federal Reserve check and automated clearing house (ACH) services would include the following:

a. Charges for check services would be imposed on depositing institutions.

b. Prices for interoffice items deposited locally might include both a local processing charge and a uniform national charge.

c. Charges for automated clearing house (ACH) items could either be imposed on ACH associations or directly on financial institutions using the service.

d. Prices for automated clearing house services would be set to encourage the use of such services and to reflect mature volume levels.

It is anticipated that schedules of charges for System services would be announced for public comments, and implemented in two phases:

First phase: Charges for Federal Reserve payments services, including check processing, check transportation, and automated clearing house services.

Second phase: Charges for certain other services, including shipping of coin and currency to member banks, transfer and settlement of reserve balances, and purchase, sale, safekeeping and clearing of securities.

Based on the present volume of Federal Reserve Bank activity, and on the direct and indirect costs incurred by the System, it is estimated that charges imposed for System services would result in revenue to the Federal Reserve of approximately $225 million annually in the first phase and about $410 million annually thereafter. The

Federal Reserve does not anticipate imposing charges for governmental-type functions it performs, such as conducting bank examinations and monetary policy and certain activities associated with issuance and destruction of Federal Reserve notes.

Access to Federal Reserve Facilities. At present, Federal Reserve Banks maintain virtually no accounts for nonmember depository institutions. However, nonmember institutions may have access to Federal Reserve operated automated clearinghouse facilities (ACH's). Nonmember commercial banks may also deposit intra-regional checks and drafts at Federal Reserve regional check processing centers (RCPC's). When charges are imposed for payments services under the proposed program, the Federal Reserve would permit all nonmember depository institutions with third party payment powers to deposit intra-regional checks and drafts at RCPC's. Nonmembers would pay the same charges as member banks for services rendered by the Federal Reserve, and would continue to be required to settle through reserve accounts of member banks.

Once the proposed program has been fully implemented, and the Federal Reserve has evaluated the impact of the program on membership and on the functioning of the payments mechanism, the System expects to provide direct and full access for nonmember depository institutions to payments and other operational services provided by Federal Reserve Banks. Access would be provided on the basis of equality of treatment with respect to balances held by members and nonmembers; balances held by nonmembers would be equivalent to the reserve balances of members and such funds would receive similar compensation.

<u>Compensation for Maintenance of Required Reserves</u>. The third element in the Federal Reserve's proposed program relates to compensating member banks for the maintenance of required reserve balances with the Federal Reserve. Member banks are at a clear competitive disadvantage because nonmember banks generally may satisfy reserve requirements by holding interest bearing assets or balances that would be held in the ordinary course of business in any event, and this disadvantage contributes substantially to the erosion of membership. In order to reduce this inequality and to prevent further erosion in membership, the Federal Reserve believes it would be appropriate to compensate member banks by paying interest on required reserve balances. However, in no case would the amount of compensation paid to member banks after deducting service charges collected exceed 7 per cent of the net earnings of Reserve Banks (before payment of compensation). The Board will submit to Congress proposed legislation to formalize this limitation on the bank payment of interest on required reserve balances.

The Board proposes to phase in the payment of interest on required reserve balances of member banks concurrent with the imposition of charges for System services in accordance with the following schedule:

First phase: Payment of interest on all required reserve balances maintained at Federal Reserve Banks at a rate of 2 per cent per annum.

Second phase: Rate of interest payable would be increased to ½ percentage point below the average return on the Federal Reserve System portfolio, valued at book, for the first $25 million of required reserve balances at Federal Reserve Banks. Based on the 1977 return on the Federal Reserve portfolio, the rate of compensation on those balances would be 6 per cent per annum. The rate of interest payable on required balances held at Federal Reserve Banks in excess of $25 million would be 2 per cent per annum.

The Board estimates that interest payments to member banks would amount to about $430 million in the first phase and about $765 million annually thereafter, based on the current level of member bank deposits.

Effect on Treasury Revenues. Since 1947, the Federal Reserve has paid almost all of its net earnings to the United States Treasury. A portion of these earnings are attributable to the non-interest earning required reserve balances that member banks hold at Federal Reserve Banks. Nonmember institutions do not hold such balances and thus their reserve holdings are not a source of Treasury revenue. The program being proposed by the Board would substantially reduce this unequal "tax" borne by member banks. At the same time the Board recognizes the budgetary need to maintain Treasury revenues.

The Board estimates that adoption of the proposed program, in the absence of universal reserve requirements, would in itself result in a cumulative net reduction in United States Treasury revenues on the order of $575 million over a transition period of, for example, about three years,until the program would be fully in place. To eliminate this anticipated loss of revenue during the transition period, the Federal Reserve would transfer an equivalent amount of its surplus to the Treasury. The Federal Reserve's program, therefore, would not result in any net reduction in the level of revenues received by the Treasury during the implementation period.

With the program fully in place, the net cost to the Treasury would be expected to be minimal, if there were any cost at all. Although Treasury revenues would be reduced by about $300 million per year as a consequence of the actions in this program, there would have been, in any case, a substantial decline of Treasury revenues in the absence of the program. At a minimum, if attrition in deposits subject to Federal Reserve reserve requirements continued over the next four years at the average rate of the recent past, Treasury revenues would be reduced by about $80 million in the fourth year and would increase further thereafter. If the rate of attrition were at the more rapid pace experienced in New England in recent years, the loss in Treasury revenues would be about $200 million by the fourth year. The program could be expected to reduce, if not eliminate, such attrition in deposits. There might even be a gain in Treasury revenues if the program succeeds in increasing membership. The gain in revenues would be more pronounced if Congress enacted the Board's proposed universal reserve requirement legislation.

Result of the Proposal

The Board believes that implementation of the program presented in this statement is essential to the continued maintenance of a sound financial system. Implementation of its various elements should result in an environment in which financial institutions can compete on a more equitable basis, should arrest the decline of bank membership in the Federal Reserve System, and should facilitate the implementation of monetary policy.

Mr. MITCHELL. Thank you very much, Chairman Miller, for a very detailed and meticulous statement.

Chairman Reuss and I are going to defer our questions, to allow Mr. Stanton to raise a question or two. There is a piece of legislation on the floor in which he has keen interest.

Mr. Stanton, you are recognized for 5 minutes.

Mr. STANTON. Thank you very much, Mr. Mitchell. Although I would just clarify. I would hope we would all have keen interest in the Export-Import Bank. It has come out of our committee, and the legislation is due on the floor in a couple of minutes. And I would sincerely hope—I think this is the first time we have ever met when we have had legislation pending on the House floor before our committee. And I would be strongly objecting if it was not for the fact that on this legislation before us, half of the battle is, it is an education process for all Members, and so that those who don't have a particular interest in Eximbank or aren't on that subcommittee, would, hopefully, have a chance to hear Mr. Miller. And I would simply ask the full chairman of our committee if it would not be possible to have Mr. Miller return—I see we are scheduled through about August 11—for at least 1 full day of a wrapup so that we can ask him questions before we get into a markup.

The CHAIRMAN. I would certainly consider. The gentleman from Ohio well knows that we are trying to accommodate the Fed's problem. But there are other issues, and I would hope that this morning we could move back and forth between the floor, and thus both get education and legislation.

Mr. MITCHELL. The Chair desires to intervene for just a moment. We have obtained permission to sit during the time that the House is under the 5-minute rule on quorum calls and votes. I would hope that we could go into a kind of platooning system, so that some of us can go and vote and then return, and then the others will go. It is an awkward way to do it, but I realize your time is very precious, and there are certainly very heavy demands on the members of the committee.

Mr. STANTON. Well, Mr. Chairman, with the understanding that we will see you again before this committee before the legislation gets to markup stage, if it ever gets to markup stage, I will defer any questions at this particular time. And I appreciate the courtesy that was extended to me.

Mr. MITCHELL. Thank you.

There is a vote on now. I assume that is to go into a Committee of the Whole or approve the journal or something like that. Therefore, the Chair would like to continue the proceedings, letting some members go over and vote, then others can go.

The Chair will recognize Mr. St Germain, the cochairman of this hearing, for 5 minutes.

Mr. ST GERMAIN. Thank you, Mr. Chairman.

Many of us share Chairman Reuss' concern about the Federal Reserve's approaches to its membership problems. And I feel the chairman has provided real leadership in bringing this issue before the committee in a forceful and expeditious manner.

I know that you, Chairman Miller, are very anxious to see that these questions are resolved and resolved quickly. We definitely do understand your perspective. You are doing an excellent job at the Fed, and I am anxious that we do get this behind us, so that both this committee and the Federal Reserve can move forward on other issues.

To be quite frank, I have trouble with the entire membership question. I find membership by private institutions in a Government agency to be somewhat of an anomaly, though I realize it is essential for the Federal Reserve to monitor the banking system and to have access to data to carry out its monetary functions. But I am not sure that this is enhanced by membership. I have trouble with an agency charged with massive regulatory functions anxiously soliciting the people it is regulating to become members.

I think we would be appalled if the Federal Power Commission came to the Hill asking to establish a membership club with voting rights for Gulf Oil and Mobil, so that they could better maintain a check on oil reserves. And I would not want the FCC setting up membership for the major broadcasting networks. With two-thirds of the boards in the district Federal Reserve banks selected by commercial bankers, the membership of the Federal Reserve creates a real conflict of interest situation in the minds of some of us.

We cannot deal with these now. But this debate over membership does indeed throw a spotlight on the gerry-built structure of the Federal Reserve System and built-in conflicts between its regulatory functions and its bank membership, all structures, incidentally, which were in place before you arrived on the scene, Mr. Miller.

In this era of proposition 13, I think that we can all agree that the Congress is going to probably move with great caution on any proposal to pay out hundreds of millions of dollars to banks so that they will keep their membership in the Federal Reserve. I feel we must have sound, hard justification, evidence that this membership has benefits for the public and not just the Federal Reserve. And I feel that any payment of interest to large banks on their reserves must be accompanied by some kind of assurance that individual depositors at these banks will receive some benefits.

Now, if we are going to pay interest on reserve deposits of the banks, then perhaps the banks should begin to pay their customers interest on their deposits, their demand deposits. I am encouraged to see support for the idea that banks should pay for services they receive from the Federal Reserve, particularly if they are going to receive interest payments on the reserves.

Here again, the committee needs to take a look at some basic questions: Whether the Federal Reserve really should be providing all of these ranges of services to banks. Here again, we have an agency client, agency membership, agency customer relationship, revolving around these services, many of which we feel can be provided by private enterprise with no necessity involving the Federal Reserve.

While we probably have to deal with these questions on a short term basis, I think this committee has an obligation to look at the long-range issues and try to move the Federal Reserve to a point where it is dealing at arm's length with the bankers.

I unfortunately have to get over to cast my vote, and I shall return very expeditiously.

Mr. MILLER. Thank you very much.

Mr. St Germain, may I just point out that I certainly concur with you: I think the Board would be delighted to solve the monetary problem on a broader base by imposing universal requirements. That would set up an equal competitive basis without the membership "solicitation" aspect you mentioned.

I certainly hope that we can also understand that this is not a case of proposing to pay out hundreds of millions of dollars to banks in the abstract; we are proposing an equitable "tax." We should tax everybody the same way in order to reduce the competitive imbalances and so that at least all financial institutions have the same chance to seek to serve their customers. I think we all understand this. We have to find a way to address the problem, and we appreciate every input we can get in finding our way through these difficult issues.

Mr. St Germain. Thank you.

Mr. Chairman, I am going to excuse myself.

Mr. Mitchell. Chairman Miller, on page 6 in your testimony, you indicated that the Congress really tried to set up requirements that would prevent large banks from dominating the Federal Reserve System, and that was quite an accurate statement.

But, I guess my area of concern is that though the large banks are beginning to leave the Federal Reserve System, it is the smaller banks that are leaving the System in greater numbers. I think you would agree with that. Is that correct?

Mr. Miller. That has been the pattern, Mr. Chairman, but now we are experiencing increasing loss of membership among large banks.

But you are absolutely correct; smaller banks have been leaving in greater numbers in the past.

Mr. Mitchell. It seems to me that your restructuring of the reserve requirements would clearly give a greater break to the larger banks, and I just don't understand why, if there is a larger withdrawal of the smaller banks, why the smaller banks shouldn't be given a greater break under your restructuring of reserve requirements.

Mr. Miller. Mr. Chairman, we have submitted to your staff a schedule which is our best estimate of the effect of the program on various sizes of banks. The net effect on profits before taxes would be the greatest for the small banks; you must combine both the reserve requirements reductions with the payment of interest on reserve balances and the value of services that will now be charged for.

Our estimate is that banks in a class below $10 million would show, on average, about a 16 percent improvement in their pretax earnings, while banks in a class of $1 billion and over would show only 6 percent improvement. So our plan is geared toward helping the smaller and medium size banks the most. As you will note, our limitation on the payment of interest to 2 percent on required reserve balances of over $25 million means that a bank gets a great deal less benefit the larger it is. Our reason for doing that is that we believe that some of the larger banks do get more benefits—although maybe not measurable—from being members of the Federal Reserve than some of the smaller ones. So we thought that the plan should favor the smaller institutions.

Mr. Mitchell. My problem with your statement is that you indicate that the 2-percent limitation would be helpful to the smaller banks, but earlier you indicated that you had wanted us to drop the 2-percent limitation.

Mr. MILLER. Mr. Chairman, we propose to pay only 2-percent interest on required reserve balances over $25 million. We would have only so much money to spend, and this is how we would propose to spend it. But our suggestion was not to legislate this limitation. If it were legislated, of course, we couldn't make a different percentage break 5 years from now. We would always be stuck with the break at 2 percent on deposits of over $25 million.

I want to point out one other thing. You asked about the change in reserve requirements and maybe this wasn't clear in my answer. You see, most of the small banks now maintain the minimum reserves required by law; we can't reduce them further. That is why we have to use other techniques to help the small banks.

Mr. MITCHELL. Or you have the alternative of changing the law.

Mr. MILLER. Yes; if Congress wanted to lower the minimum, that would give us more room to do something; there is no question of that. But we were operating within the present statutory boundaries in proposing this particular plan.

The CHAIRMAN [presiding]. Mr. Steers, do you have any questions?

Mr. STEERS. No, Mr. Chairman.

The CHAIRMAN. Mr. Vento.

Mr. VENTO. Thank you, Mr. Chairman.

Mr. Miller, I appreciate the remarks you have made this morning and your concerns and our concerns about the erosion of membership in the Fed. In your statement you addressed the question of the Federal discount window and the arbitrage profits and apparently from what I read in the statement it sounded as though you recognized that as being a factor, but you tried to keep them at minimum. I think that was the word that was utilized.

Have you done a study on that, you know, as far as the discount window? We have some graphs that I was looking at, and perhaps there is one in your data on the same. I did not review the graphs closely, but what I have seen is that the discount rate tends to generally floor, and it sometimes is below the market, and I guess that is where we run into the problems.

Sometimes it is above the market. Has the Fed done any type of analysis of the type of profits that are made with regards to that?

You say they are kept at a minimum. What does that mean? Have you done any type of evaluation of member banks in the use of that window as to the amount of profit that is made or the amount, on the other hand, of loss incurred by member institutions that use it?

Mr. MILLER. We all know the purpose of the discount window. It is not there for the purpose of giving advantageous rates on bank borrowings or for making profits for the Federal Reserve. It is there as part of the mechanism for liquidity and for adjustment.

The discount window is administered very carefully by the Reserve banks so that it will not become used for the purpose of a bank getting a break in rates by constant borrowing.

The discount rate is usually alined, in due course, with the market, so that when interest rates are rising, it would normally tend to run below the Federal funds rate, which is the rate charged by banks to other banks for borrowing for reserve purposes. And running below slightly as it does, it is important for the Federal Reserve to be able to adjust the discount rate—to let it lag behind sometimes to make clear that general caution is needed in the upward trend of rates and also to make funds available for the adjustment process when there is a tightening of credit to enable banks to get their portfolios, investments, and securities in line with market rates without being under undue pressure.

As far as the amount of profit is concerned, I believe that in 1977, Federal Reserve earnings from the discount window were about $25 million out of total earnings of $6 billion. That is a relatively insignificant amount, so the benefit in earnings to the Federal Reserve is quite minor in relation to other Fed income.

For example, we are talking about charges for services that would run a little over $400 million or on that order of magnitude. So, "profit" is really a small item the way the discount window is administered.

Mr. Vento. Do you think it offers any inducement to members? Is it a benefit to members or not?

Mr. Miller. Its liquidity feature is extremely important.

Mr. Vento. So in terms of looking at the services that are offered by the Fed, it represents a substantial service, does it not?

Mr. Miller. It represents a substantial service to be able to maintain liquidity and keep your business going; yes.

Mr. Vento. The thought was that we were going to provide some other inducements in terms of benefits for membership, such as interest that that could be considered, but your suggestion is, it is important to monetary policy, and I note the chairman's comment that you did not vote in the majority on the last discount change.

Was it set improperly at that time, do you believe?

Mr. Miller. In hindsight I think it probably was the correct decision. At the time I wanted to see a little more data on what was happening to the aggregates. We had moved rather rapidly in tightening up, and I thought it was appropriate for us to get a little more data. In relation to market alinement, the rate should have gone up. My thinking was, "Let's be careful about what's happening in the whole economy and move cautiously and see the data first."

I thought we should wait a little. As it turned out, the aggregates were quite strong, so I would have to give credit to my associates who were able to perceive that and voted for more rapid action.

Mr. Vento. Of course, we have a number of legislative proposals. One provides for reserve requirements. I paid special attention to your comments about what your intention was with the bill in terms of providing universal reforms.

I think the point that I would key in on, and I think there is a difference between what you said and what the bill says, is the rule and regulation power, and the very fact that you have the power to modify that in a very substantial way in changing the reserve requirements of nonmember institutions. I think it is very apparent in that legislation that there is a tremendous extension of responsibility mandated at the Fed.

Apparently, you feel properly mandated—but that I have concern about, and to some extent maybe it is based—I think we are really dealing with the Fed regulatory responsibility in terms of financial institutions, not really primarily with monetary policy.

Only tangentially are we dealing with that, and the question comes back: Is there anything less safe about—or what is wrong with the FDIC regulation? Maybe the Federal Reserve System shouldn't have as many banks in terms of membership. This question comes to my mind, so what about the proposal that you have made for universal and the rules and regulations impact upon these other financial institutions, regulatory roles.

And is there anything less safe about the way they are operating now? Are there more failures or less failures? This gets back to a question that the Chairman raised initially in his statement. I think it deserves an answer.

Mr. MILLER. Congressman Vento, let me break that question down into several points. First, when the Federal Reserve System was established in 1913, my guess is that a very high percent of the transactions accounts were maintained in banks that became members, and therefore that the decision of Congress to give the Federal Reserve some flexibility in setting the reserve requirements for the Nation's entire transactions system was a conscious one.

That has changed because of institutional changes, but I am not sure there was ever a corresponding change in congressional intent. I think it would be wise to reinstate a system where the National Government, if you will, does look at the entire system, establish equitable reserves, and have some flexibility to adjust them to economic and money conditions.

We do not, however, suggest that the Federal Reserve also be given authority to regulate nonmembers. We are not suggesting that that be done at all; we are not trying to extend, and do not desire to extend, our regulatory base beyond the control of reserves.

The third point is that the FDIC insures deposits up to a certain amount, but this does not insure liquidity in the banking system. If a large clearing bank which is a nonmember and has a network of correspondent accounts of nonmembers should get into trouble—as we have seen happen in the crunches of 1973 and 1974—then the whole pyramid could be in trouble. The customers would never lose their money, but the liquidity crunch would come down on those banks.

They would suddenly be unable to use their funds in the ordinary course of business, and suddenly the process of doing business and supporting their customers in commerce and industry could be very much in jeopardy. That doesn't mean there is any ultimate loss or any lack of safety for individual deposits up to the $40,000 limit of insurance, but it does mean a loss of liquidity.

A member bank can come immediately to the Federal Reserve. As you know, a few years ago, the Federal Reserve made $1.7 billion available to assure very quickly that the liquidity of a large bank was maintained. The Federal Reserve lost no money; it charged interest, but it solved the bank's liquidity problem.

Mr. VENTO. My time has expired, but historically, I guess, in the thirties there was a great modification in spite of the discount, when in spite of the liquidity, a third of the banks went out of business. So, I think the power that you ascribe to it, while maybe it is a factor I think it is hardly the potential dealings with major economic disruptions in terms of that historically.

Now, maybe today there is some persuasion that could be brought to bear that could demonstrate the argument, Mr. Miller, that you are presenting to us.

My time has expired. I hope that I can submit some questions in writing.

Mr. MILLER. I would be very happy to answer them. I did not answer your question about bankruptcy. With the chairman's permission, I would just point out that since 1947—which is as far back I guess as we have data—our data show that .72 percent of the average number of member banks failed, while 1.33 percent of nonmember banks failed—a much higher percentage of failure among nonmembers.

Mr. BROWN. On that, Mr. Miller, do you have the figures of assets of the banks?

Mr. MILLER. Yes, we submitted a complete list to your committee.

The CHAIRMAN. That is in the 16 questions.

Mr. MILLER. It is. I could take the time to go over them.

Mr. BROWN. All I was going to say, Mr. Miller, was since you are talking about numbers of banks, showing the disparity, .72 versus 1.3——

Mr. VENTO. If the Chairman would just indulge me, I think the basic question here is why can't nonmember banks use the Federal discount window today. If it is a small service and it is important to liquidity—and we are talking about making up reserve requirements and they are so essential—why don't we let nonmember banks then use that discount window and aim that type of control there?

The CHAIRMAN. The time of the gentleman has expired, but he will be re-recognized.

Chairman Miller, I believe you are a golfer, among other things, are you not?

Mr. MILLER. I am accused of using a wood in the wrong places, but I am a golfer, yes.

The CHAIRMAN. I would just guess, too, that the country club which you belong to, due to inflation and higher salaries and everything else, has had to raise its dues and initiation fees in recent years, reflecting general trends.

Would that be about true?

Mr. MILLER. That is the case in most clubs, yes, sir.

The CHAIRMAN. And wouldn't it also be true—I don't have the charts to back me up—but hasn't there been some erosion of membership among country club members because of increased dues and charges and inflation and this and that?

Mr. MILLER. That it is an interesting point. I don't know, but I suspect there has been an overall increase in membership. But one thing for sure, there has been no increase in the right of nonmembers to play without paying. [Laughter.]

The CHAIRMAN. If you and I could have access to some $500 million a year of the taxpayers' money, increase the Federal deficit though it did, and could subsidize the present members of golf and country clubs, not to resign their membership, it probably would have a salutary effect on membership maintenance, would it not?

Mr. MILLER. That is not the purpose of our plan.

Our preference is to try not to look on this problem as one of membership. Membership illustrates the limitations of our present system, but perhaps it is just as well—perhaps preferable—to solve our problem by imposing universal reserve requirements so that those who do have the privilege of providing banking services to the public are all on an equal basis, so that all pay the same dues and have the same privileges.

The CHAIRMAN. Call them what we will, it is in this world of power in which the Congress and the Federal Reserve and the Supreme Court and the administration all live, it is true that there is a question of political power and clout involved here, is there not?

For example, the Fed becomes stronger and more powerful as it retains and aggrandizes its membership list. It is also true that as the Fed retains or prevents the defection of members, it is able to assume regulatory authority or control over them which perhaps would go to some other agency like the Federal Deposit Insurance Corp. otherwise.

My question is: Since, in fact, 72 percent of the Nation's banks don't now regard membership as an intolerable burden, despite which you and I think that something more should be done to make monetary control firm and forceable, can we really justify spending $500 million or so of the Federal taxpayers' deficit-causing dollars in interest subsidies to all member banks without discriminating between those banks for whom the cost of membership exceeds the benefits and those for whom they don't?

I think that states my difficulty about as well as I can.

Mr. MILLER. Mr. Chairman, I don't believe there's anything about power in our proposal.

It certainly makes no difference to the Federal Reserve whether the monetary problem is solved in terms of preventing withdrawal of members who are subject to our reserve requirements or legislating a national financial policy that imposes reserves on nonmembers; we would prefer the latter. We do not seek to expand our regulatory control over anyone, and there is no reason in the world that our monetary authority could not operate—as it does in many countries—by merely requiring that all institutions be subject to its monetary control; Federal Reserve regulatory control is not necessary.

The other point I would make, Mr. Chairman, is that this is not an exercise in trying to subsidize banks. The System as it was adopted by Congress allows for optional membership and even allows for rechartering of national banks as State nonmember banks. All you have to do is look at chart XI which compares the cost of trying to correct this problem with the cost of not correcting it; you will see that the costs converge and that we are not subsidizing anyone. After all, how could it be called a subsidy when a bank that elects to leave us and take the money we are holding could earn interest on that money at the full market rate?

We are proposing to pay less than that. We are giving some benefit to members, but we are not requiring that anybody become a member. We would like the solution to be universal reserves. I am sure Congress might want to couple a universal reserve requirement with payment of interest—even to nonmembers—so that at least the earnings otherwise foregone would not show up in the cost to their customers of doing business. That would reduce the interest rates that banks and other financial institutions must charge and, therefore, work in favor of some of the other objectives we all share.

The CHAIRMAN. Well, I thank you for your response.

I would just have one very quick question.

Do you agree with my fundamental search in these hearings for that kind of a solution to the problem of a sound dollar which will have the least possible deficit-increasing impact on the American taxpayer?

Mr. MILLER. That is correct. You and I, Mr. Chairman, have exactly the same objective. We may approach it differently, and we may make different predictions about the future. My guess is that without some form of solution, the Treasury will have bigger deficits because there will be loss of membership and loss of revenues from members. The plate we pass around won't be so full.

But if we correct the problem, we will work in the direction of avoiding larger deficits, and we will gain, I think, a better system; a system more attuned to the eighties, nineties, and the 21st century; a system that can evolve—that isn't revolutionary, but evolutionary. We need to recognize in a constructive way the competitive environment that is developing and causing institutional changes in money and credit; we need to respond to make it a healthy, workable, competitive system.

The CHAIRMAN. Thank you, Mr. Miller. My time has expired.

Mr. ST GERMAIN [presiding]. Mr. Brown.

Mr. BROWN. Thank you, Mr. Chairman. Thank you, Mr. Miller, for being with us this morning.

Chairman Miller, I have not had an opportunity to go over your full proposals, but when you talk about universal reserve requirements, when you then flesh that out by saying that maybe in connection with the establishment of universal requirements, there could be something done about mandating the payment of interest, it seems to me that there is a component that is missing which has been incorporated in other legislation, and that is the component of an advisory group to the Fed which would consist of State banking agencies.

If we are going to, in effect, create an umbrella over all of our financial institutions and we are going to establish reserve requirements for nonmember State banks, for all institutions, especially if you are going to mandate the payment of interest, for instance, on reserve requirements not held by the Fed, that then there ought to be some kind of input from the other side of our dual banking system.

Does your proposal, or in your discussions have you thought about that?

In the International Banking Act, of course, you know we do do that.

Mr. MILLER. Yes, sir.

Congressman Brown, we have not studied that.

I would say, however, that there may be some misunderstanding. Certainly, we are not proposing to mandate the payment of interest on reserves other than required reserves held by the Federal Reserve. We are not asking States to pay out money.

Mr. BROWN. I thought a minute ago just in your very last colloquy with Chairman Reuss that you said in connection with establishing universal reserve requirements, that it might be well to provide for the payment of interest even by nonmembers.

Mr. MILLER. If the Congress adopted both of our proposals, we would have both universal reserves and the payment of interest by the Federal Reserve on the required reserves held with it; that is correct. But neither proposal would require States to pay interest.

Mr. BROWN. I misinterpreted your last statement.

Mr. MILLER. I may have been a little fuzzy. I hope my statement is clear now.

Mr. BROWN. But it seems to me, in connection with the establishment of reserve requirements, you also have got to, in effect, define what is an appropriate reserve, what it can be held in, and—or else your reserve requirements would be meaningless, and when you get into those kinds of things, shouldn't you have some input from the other side of the banking system?

Mr. MILLER. Under the present system, what is counted for reserves is coin and currency held in the vaults, plus cash balances held at the Federal Reserve. I don't think that system should change.

Mr. BROWN. But Chairman Miller, I am not talking about the Fed members. I'm talking about the nonmembers who are going to have universal reserve requirements. I understand that you would require of all institutions, members or nonmembers, but then someone has to determine what is a proper reserve, and States determine that presently for the nonmembers.

Mr. MILLER. Perhaps I am not being clear, but I am trying to explain that under a universal reserve requirement there would not be an option to hold reserves in interest-bearing securities. If the Federal Reserve had that provision now, we wouldn't have a problem. You see, the burden on the Federal Reserve member as compared to the State nonmember is that the nonmember may now hold reserves in interest earning forms.

Mr. BROWN. Then your universal reserve requirement would be that it would have to be held within the Fed system.

Mr. MILLER. Yes; held with the Fed, the same as for members. But there would be no regulatory authority over nonmembers. Let me come to the bottom line: I have no objection to considering your suggestion. I have not done that but I would be glad to consider whether we need to set up a consulting arrangement with the States.

By instinct I believe in coordination and in working together; I have no problem with that. I don't know how your suggestion fits in this context. I was trying to make clear that this proposal calls for reserves to be held at the Fed.

Mr. BROWN. I was under the impression you were talking about universal reserve requirements, otherwise the establishment of an amount but not necessarily to be held by the Fed, and I understand that now.

Mr. MILLER. Reserves would be held at the Fed.

Mr. BROWN. I think you in your statement said, that nonmembers would not have access to the discount window.

Mr. MILLER. That is correct, other than on the same terms as exist under current law.

Mr. BROWN. Well, as I recall, in the International Banking Act, when we said that all State or federally chartered must maintain reserves with the Fed, that we said that they would have access to all Fed services in that legislation, did we not?

Mr. MILLER. Yes; that is correct.

Mr. BROWN. Well, why would we say that a foreign bank shall, by being required to maintain a reserve with the Fed, have access to all services, including the discount window, but a domestic nonmember bank required to do the same thing would not have access?

Mr. MILLER. There is no reason why we could not decide that the proper system would be to have universal reserves and universal access. If we did, I think the consequence would be to discontinue capital stock investments by members because they would be the only ones doing that.

But there is nothing wrong with your line of reasoning.

Mr. BROWN. Thank you. I wish you would look at it.

Is there anything to stop the Fed in connection with its rendition of services to, in effect, become competitive cost-cutting so as to move commercial correspondent banks out of the business?

Mr. MILLER. Just the reverse would happen, I think.

What would be best——

Mr. BROWN. Since the Fed doesn't have to make a profit whereas commercial banks do——

Mr. MILLER. Our proposal on pricing is to price competitively, but not to undercut the market. Our view is that it is healthy to have the Federal Reserve provide services so as to insure a secure system of payments and the basic services that are essential to a safe central bank. But we also look with favor upon the growth of optional, innovative, cost-effective techniques for handling services. And we think pricing would bring about that trend and would probably increase the participation of the private sector in the performance of the services.

Mr. BROWN. I still have a further question, Mr. Chairman, but my time has expired, and I don't want to impose upon the Chair's generosity, unless the Chair will allow me one further question.

Mr. ST GERMAIN. Briefly.

Mr. BROWN. Just one final question.

As I recall, the studies I have seen say that small banks, small member banks, disproportionately use services compared to reserve requirements, which means that in connection with the service charge vis-a-vis earnings on reserves, the small banks would be impacted disproportionately to large banks.

Any comment?

Mr. MILLER. I don't believe that is true.

Our studies indicate that the large banks use the services more; they use the access to Federal Reserve services to provide services for their correspondents.

You will find that our services are actually used more by the large banks.

Mr. BROWN. As a proportion of reserve requirements?

Mr. MILLER. I will put it another way.

Under our proposal, net benefit—taking into account the reserve requirement cuts, the compensation payment, and the charges for services—will be proportionately greater for small banks than for big banks.

Mr. BROWN. I guess we have been looking at different studies then.

Mr. MILLER. I will recheck that, but that is my impression.

[Chairman Miller subsequently submitted the following information for inclusion in the record of the hearing:]

To date, the evidence on what size bank receives more services per dollar of reserves is incomplete and somewhat contradictory. There are at least three studies which address the utilization of Federal Reserve services by size of bank:

1. A Board staff study released in June 1977,[1] found that while all sizes of member banks suffered some burden of membership, the benefits of Federal Reserve services were proportionately greater for large members than for small.

2. A study by the Federal Reserve Bank of St. Louis,[2] based on a survey of member banks in the Eighth Federal Reserve District, also concluded that the implicit return on required reserves—calculated as the value of services used divided by required reserves—increased with bank size.

3. However, a study by the Federal Reserve Bank of New York,[3] based on a sample of Second District banks, reached the opposite conclusion: that the annual return on required reserves of small members was proportionately greater than for large members.

The contradictory conclusions from these studies are probably due in part to the alternative methodologies employed as well as the different samples on which the studies are based. In order to provide more information on this issue, the Federal Reserve has conducted a System-wide survey of member bank usage of check clearing services. The results of this survey will be available in the fall.

Mr. BROWN. Thank you very much.

Mr. ST GERMAIN. Mr. Miller, in addressing one of the questions to Mr. Vento, you gave some statistics on bank failures from 1943 or 1945 to date.

I asked the staff subsequently to check something out for me, and of course, I have done a little work in my subcommittee on bank failures. It depends upon how you read the numbers, but the staff confirmed to me—and your staff might want to check this out—that of bank failures from 1975 to 1977, 86 percent of the assets of the failed banks were in member banks, so that I don't think we would want to pin anything on the number of failures of members as against nonmember banks, because those numbers can be jumbled around to a great degree.

Mr. MILLER. You could always pick a short enough period to answer the question in the way you want; statistics are very convenient sometimes.

Mr. ST GERMAIN. That is right.

Mr. Lundine?

Mr. LUNDINE. I have two questions that I think are related.

First of all, cannot monetary policy be conducted solely by open market operations?

Now, I am not asking if that is desirable; I am asking if it is possible.

And the second question I have that I believe is related is: are universal reserve requirements really necessary for monetary control?

Mr. MILLER. To answer your first question, if Congress should take away all of the other instruments of monetary policy, certainly open

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[1] "The Burden of Federal Reserve Membership, NOW Accounts, and the Payment of Interest on Reserves."

[2] "Utilization of Federal Reserve Bank Services by Member Banks: Implications for the Costs and Benefits of Membership," R. A. Gilbert, August 1977.

[3] "A Study of the Relative Usage of Federal Reserve Services by Member Banks in the Second District," S. R. Hume and K. S. Russell, January 1978.

market operations alone would work. They would have to. So in terms of, not desirability, but possibility, the answer is yes.

I have to footnote that by saying that, as far as whether that would be desirable, everybody's view is to be very cautious about doing that. We cannot predict future circumstances, and there certainly will be times when other techniques should be used. As a matter of fact, I think we should always be looking for better ways to conduct monetary policy, and while "the desk" has been the primary tool recently, it may not always be.

I pointed out that if there were a low level of debt financing by the Federal Government—if the Federal Government reduced its deficits and had less securities outstanding—it might be more difficult to exert monetary control through the open market. We might need reserve requirement changes as one of the means to put credit in and take it out of the system.

Second, universal reserves would greatly aid in conducting monetary policy, because they would reduce the degree of unpredictability of the aggregates.

On chart X, we were endeavoring to give you some idea of the fact that the greater the percent of deposits subject to reserves, the more predictable the money figures. If we had universal reserves, the point of unpredictability would be on the left side of the chart; that is, the degree of variation in predicting M_1 and M_2 would be quite small. As you move to the right on that chart—that is, as the percent of deposits not subject to reserve requirements increases—the degree of unpredictability goes up very rapidly. That, of course, happens because as the transactions flow between member and non-member banks, we have control only over the members, and it becomes more and more difficult to exercise monetary policy because we are not sure of its impact.

So the closer we come to universal reserves, the better our ability to predict the consequences of our policies and therefore to make more certain policy and more sound policy.

Mr. LUNDINE. On page 16 of your statement, you say that: "The discount rate, too, has a useful role to play as a signal of policy. For instance, it can be held back when market rates are rising to suggest a certain caution about future rate developments to the market."

Several weeks ago the Board voted on discount policy, and it was reported that you were voting in the minority in that case.

What kind of a signal were you trying to give at that time? And what kind of a signal do you anticipate that the majority was trying to give?

Mr. MILLER. The majority felt that the conditions of the market were such and the conditions of the economy were such that the discount rate should be raised to aline it more closely with the Federal funds rate.

At that time, I felt that we had already taken a number of steps to tighten monetary policy and that it would be wise to get a week or two more of data—actual reports of what was happening to the aggregates, where there is some lag in effect from our policy—before making that decision.

I was not trying to signal to anyone. I was merely trying to wait for a little more information before I made my judgment.

Congressman Lundine, as far as using the discount rate as a signal—the point I make on page 16 of my testimony—just think back to the credit crunch of 1974 and the kind of wild gyrations we had, with an inverse yield curve and short term rates being higher than long-term rates. That was a very unsettling period.

At that time, the Federal funds rate went up to 14 percent, I think, but the discount rate never went over 8 percent. If the two were linked together, you would have an erratic situation, and the ability to manage a credit crunch would be greatly lessened. In 1974, on the other hand, the Federal Reserve was able to make funds available to insure liquidity at a discount rate that did not aggrevate the already difficult circumstances. So I think there are periods when we need that management ability.

Some countries have linked their discount rate to the market; I know Canada did between 1956 and 1962, but has now uncoupled the rates based on this experience. They felt they had lost something. We talked to the Governor of the bank the other day and asked him about this—since the issue was coming up here—and he said he was one who favored getting back control over the discount rate. As another arm of policy, he found it very helpful and, lacking it, he found himself at a disadvantage. So Canada has reversed itself, one example of experience from which we might learn. The United Kingdom has recently uncoupled its rates, too.

Mr. LUNDINE. Thank you, Mr. Chairman.

Mr. ST GERMAIN. Ms. Oakar.

Ms. OAKAR. Thank you, Mr. Chairman.

Chairman Miller, throughout your testimony you have defended membership in the Federal Reserve on the grounds that it appears to insure safety and soundness of the banking system, but on the basis of data, we find that from 1973 to 1977, 86 percent of the assets in failing banks were in member banks.

Dollar for dollar, don't you think this attests to the relative safety of independent, nonmember banks?

Mr. MILLER. That was a very traumatic period, and of course, one or two large member bank failures in a period of very serious economic shocks could distort the figures. As was just mentioned, those figures certainly would indicate that membership itself does not prevent bankruptcy; indeed, it doesn't and it shouldn't.

But what membership did, of course, was to insure that the seriousness of consequences to the banking system was minimized. The fact that there was a very orderly way of handling that situation, with so little disruption, was greatly aided by the immediate availability of the window and the immediate possibility of using Federal Reserve resources to make adjustments and reorganize.

So one view is to number the membership failures, but the other is to analyze the consequences of a failure. When there is a failure, there is the safety of the immediate availability of Federal Reserve resources.

Ms. OAKAR. But you would agree that most of the failures happen to be members.

Mr. MILLER. In that particular period, yes. Over a longer period, no. And, of course, as I said, you just need to have a couple of failures of banks with large assets—which you will recall was the case during that period—to bring the average figure up, and so there is some statistical distortion for that period.

Ms. OAKAR. Chairman Miller, it is true that the larger banks traditionally do belong to the Federal Reserve, and on that basis I want to ask the following questions.

Can you tell me how the following payments would improve monetary control, promote equity, and help the membership problem. Just using your estimates, which are based for some reason on a Treasury bill rate of 4.55 percent, the payments under your proposal, H.R. 13477, would be $26 million to the Bank of America, $26.3 million to Chase Manhattan, $15.2 million to Citibank—the 10 largest commercial banks, $146.2 million, and all of this just in the first year of your plan, and it appears that it would grow as kind of a yearly gift to the biggest banks.

So how would this promote equity?

Mr. MILLER. The larger banks have been members of the Federal Reserve because of the number of advantages we have mentioned—the discount window, our services, the availability of a complete package of benefits.

As you say, this payment is for the first year alone, and depends upon the size of the bank and its deposits. But you must remember that when one tries to alleviate an inequitable tax—a tax that falls only on members and not on others—one can't say that just because a bank is large it should not get its proportionate share of relief. If we had a tax cut for corporations in America today, it would apply to large corporations and to small corporations.

If there were a 1 percent tax cut in America today—the 1- or 2- or 3-percent cut that is being looked at favorably now by Congress—General Motors would get more dollars' worth of tax reduction than would a small corporation, but that's because General Motors is paying more taxes and therefore its 1 percent reduction is greater in dollar terms. That is analogous to this proposal.

The Bank of America at the end of June 1977 had $1¼ billion deposited with the Federal Reserve and it earned nothing on that money. If it left the system it could pick up far more money than under our proposal just by investing that amount.

So, Congresswoman Oakar, I hope that we won't let size distort what is a natural consequence of simply trying to treat everybody alike. Large banks, whether they are members or nonmembers, must be treated the same way if we are going to have equity and fair competition.

Ms. OAKAR. Thank you, Mr. Miller.

Just one quick comment.

Using your analogy of larger corporations and the across-the-board approach and two-tiered taxation, larger corporations, however—large banks have other advantages, and I think that has to play into the analysis, also.

Mr. MILLER. Of course; that is why we are proposing to pay only 2-percent interest above $25 million. Take the case of Bank of America. If we paid 6 percent, the return would be $75 million, but we would be paying around $26 million under this proposal. If you were a small bank, you would get 6 percent on all reserve balances.

If you are the Bank of America, you get one-third of that on reserve balances over $25 million. So we have already skewed payments toward smaller banks.

Ms. OAKAR. Thank you. My time has expired.

Mr. ST GERMAIN. Mrs. Fenwick.

Mrs. FENWICK. Thank you, Mr. Chairman.

Chairman Miller, I have sort of a basic question I would like to ask you.

What is necessary for the sound dollar and the sound economy of our country?

Does it serve it better to have homogeneous banking institutions, or does it serve it better to have a variety of financial institutions to serve different purposes?

Mr. MILLER. It serves our economy better to have a variety of institutions, provided we have equitable treatment and fair competition. If you have a homogeneous system, you may also find you have a petrified one; I think we are in a living and changing world.

Mrs. FENWICK. I was thinking of regulation Q and all of that.

Mr. MILLER. Yes; this system should have equity but permit different institutions to compete.

My preference is to have more equal treatment, but to let different forms of institutions succeed if they offer better service a better way.

Mrs. FENWICK. The second thing I would like to ask you, do you think that interest rates are a more important cause of inflation or is it the supply of money?

Mr. MILLER. Over time an excessive growth of money will be the main cause of inflation. On the other hand, that growth of money has to be controlled with due regard to interest rates and the effect interest rates themselves have on cost and on the ability to sustain the economy at a level that will provide for our national needs.

If we tried to control inflation, through zero growth of money for the next 3 years, we would also have a recession or depression as the price. On the other hand, if we can restrain money growth and lean on it the right way and tolerate higher interest rates than we would like for 3 years, we can still keep the economy going. While we might still wish we weren't so tightly squeezed, we would know that we must take that course if we are to restrain the inflationary forces that otherwise eat us up.

Mrs. FENWICK. So your answer, if I understand it correctly, is that both have an influence, but that the long-term effect is the monetary supply; the short-term is the interest rate; is that correct?

Mr. MILLER. That is an adequate summary.

Mrs. FENWICK. I want to hurry——

Mr. MILLER. You said it so much quicker and better.

Mrs. FENWICK. I have a couple of others.

I am puzzled by the idea of the Federal Reserve paying interest on deposits. Are we starting down the garden path when we do that kind of thing? To change the rate, giving 6 percent below $25 million and 2 percent above brings in all sorts of complications. Wouldn't it be simpler, and wouldn't you be able to fine-tune the economy better, if there were simply nationwide reserve requirements?

And I was a little troubled to hear you say that you felt that you shouldn't say what the nature of those requirements would be. Why not?

If we are thinking about a sound banking system in this country, why wouldn't it make good, commonsense not to pour out more of the taxpayers' money or cause them any expense but, instead, just require that banks have certain reserves?

Mr. MILLER. I can't disagree with that, but let me correct one thing. I said we would not specify the form of reserves; that is not true. Reserves would take the form of deposits with the Federal Reserve.

Mrs. FENWICK. Well, you wrote here, "not putting any restrictions on nonmembers."

Mr. MILLER. No; I was talking about not having regulatory powers over banks regulated by the States, which is different. For example, examination, regulation, and supervision would not be our responsibility; but reserves would be held as deposits at the Federal Reserve Banks.

Mrs. FENWICK. Uniform?

Mr. MILLER. Uniform.

Mrs. FENWICK. All banks?

Mr. MILLER. You are absolutely correct that there is no reason in the world why an equitable system could not be created merely by establishing uniform reserves for all kinds of institutions on the same kind of accounts without paying interest. I would merely point out to you that opposition to that proposal will be heard in loud voices from those who don't maintain reserves now.

Mrs. FENWICK. But Mr. Miller, you see, I understand that. You must help us here to know what our duty is.

Now, whether we decide to do it or not is another matter.

Mr. MILLER. Your duty is to enact the Federal Reserve proposals. [Laughter.]

Mrs. FENWICK. Thank you, Mr. Chairman.

Mr. ST GERMAIN. Mr. Mattox.

Mr. MATTOX. Chairman Miller, I appreciate the portions of your statement that deal with the tax burden.

For the purpose of the record, I would like to have you explain why it would not be a less onerous burden on the free enterprise system, and on the banking system, if we were just simply to allow the member banks to maintain their reserves in some other manner than in cash at the Federal Reserve.

Mr. MILLER. Congressman Mattox, that is an alternate way to go, and I cannot disagree intellectually with the proposition that an equally fair result would attain if we had universal reserves and if those reserves could be maintained with the Federal Reserve in the form of Treasury bills or some other form of income-bearing certificate.

I cannot give you a reason why that would not be a fair solution. I can tell you that, in effect, all deposits then would have the same potential to earn the same amount. Since the impact upon Federal Reserve earnings and loss of Treasury income then would be greater, we thought that perhaps that was too bold a step to take. Your plan would have a greater financial impact on the Treasury than the plan we have suggested, which is a limited payment of interest. Interest would be earned in much the same way if institutions could maintain reserves in income-bearing paper; it just would be at a higher rate.

Mr. Mattox. Well, it seems to me that if the principal reason that banks are leaving the System is because the nonmember banks can maintain their reserves in interest-bearing instruments, then instead of doing another evil, that is, paying interest, it would be much more simple just to allow the member banks to hold their reserves in interest-bearing instruments. It appears to be a very simple solution.

I recognize that this would have substantial impact upon the income of the Fed and also on the Treasury, but through our income tax laws and in other ways, that impact, could be controlled, because we are just going to tax back all of those profits anyway. And it appears to me that instead of enacting another tax, a more simple method would be to remove that burden.

I understand that it is a bold step, but for the sake of the banking system and the free enterprise system—and probably for our economy and monetary systems—it would be a much more simple approach.

Mr. Miller. The Federal Reserve would not object to that approach if the Congress and the Treasury were willing to accept it. The Treasury would have to be heard on how that would impact upon their income.

Mr. Mattox. Thank you, Mr. Chairman.

Mr. St Germain. Mr. Patterson.

Mr. Patterson. Thank you, Mr. Chairman. Good morning.

I think the only thing we are maybe concerned more about than the deficit is inflation, and it appears that, at least there is some concern on the part of the administration as to what action the Federal Reserve might be taking in regard to keeping interest rates down.

I think a year ago you stated before the Senate that you would see the economy slowing down this year, which I think it has, and that that might mean interest rates would fall. And yet they seem to be higher than ever at this point.

Can you tell us now why what you foresaw then has not come to pass?

Mr. Miller. Congressman Patterson, I hope it was not a year ago, because I only came into office in March.

Mr. Patterson. Early this year, I guess it was then.

Mr. Miller. I have felt—and continue to feel—that as the rate of real growth of the economy slackens from its rapid pace of recovery since the deep recession of 1974–75, and as fiscal policy is adjusted to remove some of the stimulative impact that is no longer needed now to reflate the economy, the pressures will abate and interest rates will peak out and at some point turn down.

I don't recall suggesting that that could take place until later in the year, because the lag in effect of the tightening in monetary policy that the Fed has taken means that the restraining force shows up months and quarters later. The discipline that I believe Chairman Reuss mentioned—the change in tax plans and spending plans for the next fiscal year—won't begin to have effect until the fourth quarter of this year. We won't see any impact until we begin to spend less later this year and early next year.

If I have misstated this before, I would like to correct myself. I see the lessening of pressure on monetary policy from a more disciplined fiscal policy coming into play, but I only see it coming into play later this year and early next year. I have hoped that interest rates would peak in the next few months and that by next year we would see the chance for a little easier conditions in that regard.

I hope at some other hearing I haven't inadvertently suggested an earlier timetable, because I think that would be too optimistic. These things just take time to work through.

I do commend the Congress for the action that has been taken on the fiscal side, in working out less of a tax cut and less spending to respond to inflationary pressures. The change since I arrived in Washington—from an expectation of a $60 billion deficit in fiscal year 1979 to the expectation now of a $44 billion deficit—is a monumental accomplishment, and Congress should be commended for responding so quickly. Four or five months is a very short time in which to make that kind of policy change.

Mr. PATTERSON. With that kind of change in fiscal policy, will this alter plans that you might have in regard to monetary policy?

Mr. MILLER. Inevitably. It will make it easier to exercise monetary policy and reduce the pressure on monetary policy from what it otherwise would have been. In that sense, yes; it will certainly make it possible for monetary policy to be operating more comfortably as these changes take effect in due course.

Mr. PATTERSON. Charles Schulze and Alice Rivlin yesterday, I believe it was, both predicted that the economy would not plunge into a recession next year, provided that the Federal Reserve Board does not tighten credit so much and that Congress passes some administration-requested tax cuts.

Could you comment on that?

Mr. MILLER. The economy should not go into a recession. There is no intention and no desire on the part of the Federal Reserve to bring that about, and neither the administration nor Congress seeks it. We all seek to balance our policies and actions at this point so as to restrain the forces of inflation and, if necessary, keep the rate of growth of the economy lower than we have experienced, but not to dip into a recession. I don't believe that would contribute adequately to reducing inflation, and it would have other undesirable side effects.

So it is a matter of intention, and we accept the challenge as reflected in the statements you quoted.

As to terms and results, all of us will have to exercise extremely sound judgment in the next few months to be sure we don't overshoot in any direction and trigger either too much inflation or too much slowdown—either one. So this is a very difficult period when we must walk through a very narrow passage to get where we want to go.

Mr. PATTERSON. Thank you.

Mr. ST GERMAIN. Mr. Wylie.

Mr. WYLIE. Thank you, Mr. Chairman.

I must say, Mr. Miller, that I, as kind of a journeyman member of this committee, feel very comfortable with you as Chairman of the Federal Reserve Board. I was not sure that was possible for me after Dr. Burns. But you have certainly handled yourself in such a way that you have instilled confidence in the American public that you are competent.

Do you feel that the growth of wholesale banks would lead to a loss of membership? And I thought maybe Mr. Mattox would ask this question or refer to this. He offered an amendment in committee to the financial institutions regulatory bill which was adopted, that would allow for the national banks to invest in the stock of State-chartered banks, and therefore form a wholesale bank.

Mr. MILLER. I think this could have an impact. You know, we do have the experience now of multibank holding companies, where only one or two of the banks are members of the Federal Reserve, but the whole network receives the benefits. This does have a somewhat negative effect on membership and is perhaps a parallel example. If banks could aggregate their activities in a way that reduces the need for access to the Federal Reserve services, and take a risk on liquidity—which is maybe not a good thing to do, but given today's pressures, institutions will do it—then there could be some possible risk to membership.

Mr. WYLIE. Should we have an amendment to that section which would prohibit the wholesale banks from joining the Federal Reserve System, then, so that the retail banks—or they would be encouraged to maintain, I should say, membership?

Mr. MILLER. I would have to look into that. It could be, because of the way of handling correspondent business, that even such an amendment would not restrict the possibility of "wholesaling membership," as it were. I am not sure whether that would work; there might be a way around it. Perhaps we should take a look at that problem. I had not really been aware of a movement along those lines.

Mr. WYLIE. It is section 1411 in the financial institutions regulatory bill which will be coming to the House floor very soon. I am not sure, as I said a little earlier, that I don't want to talk about this. But I thought this did come up during the discussion of that amendment.

Mr. MILLER. May I look into that, because it sounds like an important matter, and I just may not be up to date on it.

[Chairman Miller subsequently sent the following letter to Congressman Wylie and a similar letter to Chairman St Germain:]

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

G. WILLIAM MILLER
CHAIRMAN

August 14, 1978

The Honorable Chalmers P. Wylie
House of Representatives
Washington, D. C. 20515

Dear Mr. Wylie:

During hearings conducted by the House Committee on Banking, Finance and Urban Affairs on membership in the Federal Reserve System on July 27, 1978, you asked for our views regarding section 1411 of the Financial Institutions Regulatory Act of 1978 (H.R. 13471). This section would authorize national banks to purchase shares of stock of a State-chartered bank, subject to certain limitations, where the law of the State in which the national bank is located permits State-chartered banks to purchase such stock. The limitations are that: (1) only up to five percent of any class of voting securities of such bank may be purchased by any national bank; (2) the total amount of such stock held by a national bank cannot exceed five percent of its capital stock and paid-in and unimpaired surplus; (3) the State-chartered bank whose securities are purchased must be insured by the FDIC; (4) the stock of such bank must be owned exclusively by other banks; and (5) such bank must be "engaged exclusively in providing banking services for other banks and their officers, directors, or employees."

During the membership hearings, you raised questions concerning this section's effect on membership in the System and the possible need for an amendment prohibiting such banks from joining the Federal Reserve System.

This section applies to national banks only. Since all national banks are required by law to be members of the Federal Reserve System, allowing a national bank to own stock in such a bank would not cause it to drop its membership. In fact, it should remove any incentive to change to a State charter and leave the System in order to participate in the ownership of such a bank.

There would be cause for concern regarding such banks in general if such a bank were allowed membership in the System. It could obtain access to Federal Reserve payment mechanism facilities and other services for those banks that owned it. The owner banks would then have an incentive to drop their membership. No additional legislative authority is needed since it has been our policy to deny such banks membership under the authority given us in section 9 of the Federal Reserve Act for the following reasons: (1) the institution is not open to the public; (2) the shareholders themselves are institutions eligible to become members; and (3) as a consequence of admitting the institution, the institutional shareholders could gain access to certain benefits of membership but remain outside of the Board's regulatory authority.

We, therefore, have no objections to this section of the Financial Institutions Regulatory Act of 1978.

Sincerely,

(Signed) G. William Miller

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BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

G. WILLIAM MILLER
CHAIRMAN

August 14, 1978

The Honorable Fernand J. St Germain
Chairman
Subcommittee on Financial Institutions
Supervision, Regulation and Insurance
Committee on Banking, Finance and Urban Affairs
House of Representatives
Washington, D.C. 20515

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Sincerely,

Bill

Mr. Wylie. Apropos of that, I am rather interested in knowing how we get here. And during our discussions of the International Banking Act, we determined that other countries do not have membership in a central bank, of course. What do other countries do about reserve requirements?

Mr. Miller. As a rule they have universal reserve requirements; all banks must maintain reserves. Of course, the United States, for reasons of its development as a federation of States in a Federal system and because of State's rights and Federal rights, early on decided to have a dual banking system. Having options worked quite well for a while, when the scales were tipped in favor of being a Federal bank or a national bank or part of the Federal system.

Now that the scales have tipped the other way, we see problems arising. But most nations haves a national banking system. Every nation has a national currency, a national financial system, and a national monetary authority, and almost universally they have a national requirement to adhere to that monetary authority.

Mr. Wylie. Where are the reserves maintained and in what form?

Mr. Miller. They are maintained with the central bank or with regional banks or offices. Italy is the only major country in which required reserves all take the form of interest-bearing deposits. In all of the other countries banks must maintain reserves without receiving any interest on them, so that the system is the same as we have, except reserves are universal, and so they don't have the inequity that we have.

Mr. Wylie. Do you know offhand in what form they are maintained, Mr. Miller? I mean, like Switzerland and the United Kingdom and maybe Japan?

Mr. Miller. In the United Kingdom they do allow some interest-bearing assets to be held as reserves. But most nations require reserve balances held with the central bank or the central banking system.

Mr. Wylie. Cash balances?

Mr. Miller. Yes; with just a few slight variations as to what is counted as reserves. You know, we count vault cash, and that is a small variation. In Canada there is a slightly different variation in the form of required reserves. But the general policy is to maintain balances with the central bank.

Mr. Wylie. Well, it has been a real hairshirt to me that we may not require reserves of foreign branches operating in the United States, as you know, and I wonder why we require reserves of our own domestic banks if we don't require them for foreign banks. That is more of an exclamation than a question, I quess.

Mr. Miller. I am in favor of requiring reserves for foreign banks, as you know, and I am delighted with the progress made in the foreign banking legislation, which will, I think, get us to that point. And, of course, I am in favor of universal reserves in this country. I think that is the most equitable solution and would be the soundest one.

But I also recognize that there are many forces at work, and that there are some contrary opinions. While universal reserves is our preferred solution, we must look at other solutions if that is not possible.

Mr. Wylie. Thank you very much.

Mr. St Germain. Mr. Blanchard.

Mr. BLANCHARD. Thank you, Mr. Chairman, and thank you, Chairman Miller, for spending several hours here. I am sorry I missed your testimony and many of the questions. I was down at the White House, and a number of us were talking with the President about the problem of working together in cooperation, especially in view of the fact that there will be differences on important issues.

And that prompts me to mention that I think it is cooperation and partnership that is equally important between you at the Federal Reserve and the administration and the Congress. I have read several articles and heard a few murmurs here and there about friction between you and the leaders of our committee and Congress. And I think that has to be minimized.

I think it is essential for our system to work, for you and us to work together, not prostitute ourselves on issues, but as best we can to work together. And I think it would be most regrettable if friction grew into hostility or disagreement expanded into unnecessary friction. And I simply offer my hope and wish that there will be a partnership and cooperation, which I think our country desperately needs on a number of fronts, but particularly with regard to economic policy.

Mr. MILLER. You are certainly correct, and I will do my best to see that we work in harmony and partnership. We can't always agree on policies and issues, but I know we all have the same purpose—to do what is best for our country—and we can work in harmony to do that.

I find my own experience of 4½ months to be rather reassuring, in the sense that I feel there has been quite an open and healthy dialog with the administration, and certainly with the two committees of Congress with which I have been working primarily. I feel that the atmosphere is extremely healthy and harmonious.

Mr. BLANCHARD. In browsing through your testimony, I notice you indicate several times that you feel that the presence of the Federal Reserve in bank supervisory and regulatory areas enhances the quality of the banking system. I can understand how you might feel that way and how perhaps all of us would serving at the Federal level.

But I am wondering if you have any concrete evidence that regulation by the Federal Reserve System is better in any way than the regulation by the Comptroller or the FDIC or State banking supervisors?

Mr. MILLER. No; I don't think we would want to suggest that our examination is superior to that of the Comptroller, and we work very closely with the Comptroller and coordinate very carefully with the Comptroller and with the FDIC. Nor would we suggest that there is any lack of quality in the State supervisory area.

I am talking more about a national regulatory presence. A national regulatory authority is needed when it comes to interest rate ceilings and to many other issues. If you have too much opportunity for variation and diversion from standards, then you get an uneven financial system, and you end up with less than optimum or effective results. In their context, my remarks were not meant to suggest any sense of parochialism about our superiority; I would withdraw them if they do. My context was a national mechanism for supervision and regulation. There are other functions of the Federal Reserve—monetary control and liquidity and the insurance of a payments mechanism—

that can't be conducted except by the Federal Government. They could be conducted by any agency of the Federal Government, but they have been assigned fundamentally to the Federal Reserve. If they weren't assigned to the Federal Reserve, they would be assigned to another agency that would be the same as the Federal Reserve; that is, a central monetary authority.

Mr. BLANCHARD. But I take it your major concern really is to have as comprehensive a climate as possible to conduct monetary policy and not to regulate or supervise banks for the sake of having more members and more authority.

Mr. MILLER. I could not agree more. We do not seek to examine or regulate a single bank more through any of our proposals today. We do not suggest that, if there were universal reserves, we should be examining or regulating any more banks than Congress has already mandated that we regulate. Congress has authorized us to regulate bank holding companies, members and nonmembers, and that authority will continue to apply or else be given to somebody else. But we are not seeking to gain one piece of turf in the regulatory field from these proposals.

Mr. BLANCHARD. My time has expired. Thank you.

Mr. ST GERMAIN. Mr. Miller, I would say one thing to you. You said Congress mandated or is mandating that you regulate and supervise banks. Very frankly, you know, there are some of us who put forth the proposition that the Fed indeed should not regulate and supervise banks. So if you would like to get rid of that duty, I am sure that we would be responsive immediately to move that legislation along very expeditiously.

Mr. MILLER. Unfortunately, my time is up. [Laughter.]

I thought from something you said earlier, Mr. Chairman, that you might raise that at some later date, and I hope you shall.

Mr. ST GERMAIN. Mr. Derrick?

Mr. DERRICK. Thank you, Mr. Chairman.

Mr. Miller, we are delighted to have you. I was also at the meeting at the White House, and regret that I did not hear the first of your testimony.

Assuming that the most important function of the Fed is its influence on monetary policy, how many banks are there that are members of the Fed today?

Mr. MILLER. There are about 5,000–6,000 member banks, of which 1,100 are State member banks. As you know, national banks are supervised and examined by the Comptroller. There are about 5,700 member banks, to be more exact.

Mr. DERRICK. Well, out of the total number of banks in the United States, which is 14,000, that is something less than 50 percent. Assuming that this committee and this Congress were to pass legislation that would make it attractive enough for the banks in this country to increase their membership, say, to 90 percent, or a tremendous amount, I would suggest that the logical thing would be that you would have a greater influence by your input into monetary policy. And if that were the case, and say that 80 or 90 percent of the banks were members today of the Fed, what do you think you would be in a position to do with monetary policy; what effect do you think you could have that you may not be having today, and what would the probable consequences be?

Mr. MILLER. Congressman Derrick, our proposals——

Mr. DERRICK. You do agree that if you had the additional membership, your impact would be greater?

Mr. MILLER. Yes, sir.

Let me just make one comment before I answer the substance of your question, because you reminded me of something that I did not make clear. The proposals that we have made are not intended to attract members. I don't think the proposals we have made would attract members. I think Congressman Stanton's proposal to pay a full market rate of interest would attract members.

Mr. DERRICK. I understand that.

Mr. MILLER. We are just trying to stop the loss. Now, under our universal reserve proposal, we would have reserves on about 80 percent of transactions deposits, and that would very much enhance our capacity to control monetary policy, because it would enhance our ability to measure the relationship between reserves and credit on a much larger bundle of deposits and lessen the opportunity for divergence from our monetary targets. We developed one chart—chart 10—which we discussed when you weren't here, I think. It is worth looking at because it shows that the more reserves are outside our control, the more difficult it is to predict the relationship between our actions and the growth of the aggregates.

Mr. DERRICK. The substance of my question, of course, is that, assuming we were to erase this liability for you, what do you think that you could do that you are not now doing, and what do you think that the results accruing therefrom would be?

Mr. MILLER. What we could do, first, is to gather more accurate data on the current money supply, which would make our policy decisions sounder; we would be reacting with better knowledge of the facts. Now we act on the basis of many estimates and best guesses. The closer we get to currently reliable data, the more likely our judgments will be sound and not cause erratic movements in the economy that come about because of false or misleading information.

Second, the leverage of our actions on real results, would be more direct. Therefore, our ability to push the throttle or retard the throttle and achieve a certain consequence in the economy would be far more direct. The result would be a much healthier control—less guessing, and more likelihood of assurance, under conditions such as we have today, for example, that we would not bring on a recession by mistake.

Today, with so much outside of our control and so much guessing, we could inadvertently make a mistake. The probability of our being wrong would be greatly reduced if we had this control.

Mr. DERRICK. The results of your being wrong would also be more catastrophic.

Mr. MILLER. The result of being wrong would be the same: the economy would be in bad shape.

Mr. DERRICK. Let me ask a question in another area: Have you thought that it might be necessary, if the Congress were to enact this legislation or some close facsimile, to restructure the gunning mechanism of the Fed? What I allude to is the inclusion of more input from savings and loans, credit unions, other members of the financial community.

After all, you are including them, in a sense, in your suggestions.

Mr. MILLER. I think that deserves consideration. To date, Congressman Derrick, we are only seeking to establish reserves on so-called transactions accounts, and at this point that does not impinge fundamentally upon those other kinds of institutions. We might be mixing apples and oranges, but I am not philosophically opposed to looking at your question and seeing if better coordination would be desirable.

Mr. DERRICK. Well, I would suggest to you that if you do this I would see it as a natural outgrowth.

I thank you very much. And thank you for appearing before the committee.

Mr. MILLER. Thank you.

Mr. ST GERMAIN. Mr. Grassley.

Mr. GRASSLEY. Thank you, Mr. Chairman.

I want to echo the compliment that Mr. Wylie, of Ohio, paid to you, and say that I watch what the Chairman of the Federal Reserve Board does more even than what the President of the United States does, because I figure it is that important a position and can have that much of an impact on our economy.

I have read some speculation in the newspapers to the effect that you might be moving a little bit away from your independent position. At this point, I am just going to consider that speculation, and I hope, in fact, that that is not the case.

Mr. MILLER. Let me assure you it is not the case now and will not be the case.

Mr. GRASSLEY. Mr. Miller, would you please tell us what actions, if any, the Fed will take if the House and Senate fail to act on any of these proposals during this session, the proposals that we are discussing here today?

Mr. MILLER. Mr. Congressman, I am approaching this issue with great cooperation from the chairmen on both the House and Senate committees and therefore with the high expectation that, because the issues are not new and because there is such willingness to address and resolve them, that we will get a resolution. I have not really addressed the issue of alternatives, so I suppose I have to answer you by saying that I do not know. The Federal Reserve would have to go back to the drawing board and see if there were other things that could be done in the national interest—to be sure that we do not continue to have the adverse consequences of loss of members.

But I hardly want to think of what could be done and what would be done, because I have to believe that we are going to get a resolution from the Congress, which would be best.

Mr. GRASSLEY. Because there are only about 35 days left to work this all out before we adjourn, you would not be taking any action before next January and the convening of a new Congress?

Mr. MILLER. You know that the timetable in our preliminary proposal, attached to my testimony, was to make some reserve adjustments, within the statutory limits that now exist, at the end of this year. We plan to introduce the first tranche of service charges on July 1, 1979, and at that time to make the first payment of interest at a low rate. We could have the full plan in effect in 1980.

So I do not think we face any crunch here if there is an orderly process. I know that substantial time is needed in order for us to get those mechanisms in place, so I am very hopeful that the Congress will give us our marching orders before this year is out. But if they do not, we will take the next step when it comes.

Mr. GRASSLEY. At what point does the level of deposits under the control of the Fed affect the Fed's ability to conduct monetary policy efficiently?

Mr. MILLER. We are already at that level. We are already at a level where the ability to measure impact and to have an adequate monetary handle has been substantially eroded. We already have so much play in the controls that when we push we do not get as quick a response. Where the absolute trigger point is, I do not know. But, it has already, in my opinion, gone too far when you consider that we were at 85 percent of deposits in 1950, that by 1965 we were still at about 85 percent, and then we suddenly dropped to 73 percent in the last 10 years. One begins to worry because it certainly is going too fast and too far.

Mr. GRASSLEY. Following up on the question of the competitive nature of your services versus those that would be offered by the private sector. If the legislative proposals before us on the pricing of services were to become law, would the accounting procedures at the Fed reveal any cross-subsidization of the services provided, in order that we could police the pricing of services so we do not get into the same problem we have with the postal service?

The postal service says that they just cannot account for their overhead, hence they will not accept the argument that first class subsidizes fourth class. Therefore, we get into the argument over whether or not parcel post is competitive with the United Parcel Service, as an example.

So, I am asking the same question of you. Will your accounting practices show up whether or not, in fact, there is any cross-subsidization?

Mr. MILLER. Congressman Grassley, the Federal Reserve is in the process—we have gone a long way—toward developing a pricing system, and we are continuing to perfect it. I would say that, today, it might be slightly inadequate for your purposes, but by the time this plan is in effect the data would disclose what you would need to know in that respect.

Let me say that "subsidy" is a difficult word, but I think you are approaching the question correctly. First, let's see what the data show; then, we can argue what "subsidy" is. We will be able to get you the data.

You know, there are new technologies—automated clearinghouses, electronic transfer of funds—and a nationwide deposit system. Like any new product in business, there is a learning curve and an investment to start it. One does subsidize a new airplane when it is first built, or a new automobile when it is first introduced, in order to get up to a level of production that shows a profit. There will always be that kind of question: How do you price a new product so that when you get up to speed it will be profitable, so to speak?

So I would not want to mislead you; we will always have tough issues to face if we are going to be a living, breathing, moving organization that is trying to be creative.

Mr. GRASSLEY. Thank you, Mr. Chairman.

The CHAIRMAN. Mr. Pattison.

Mr. PATTISON. Thank you.

I notice we have a quorum call we have to answer, so I will try to be brief, and perhaps you can also be brief in your response.

In your statement you indicate that under the Federal Reserve proposal, H.R. 13476, nonmember depository institutions would have to report on their deposits and certain other items to the local Reserve bank for monetary management purposes.

As far as monetary control is concerned, wouldn't this access to that data essentially obviate the need for imposing Federal Reserve-determined reserve requirements on nonmember banks and thrift institutions?

Mr. MILLER. The availability of data along the lines we have suggested—or Chairman Reuss has suggested—would be very helpful in giving us, at least, the current situation. It would not help us, however, in terms of the degree of error that exists as the impact of our actions in reserves works its way through the system and reflects itself in money and credit.

We would gain by being able to read history, but we would not be able to predict as well what the next move should be. It would be a step forward, but not as complete a step as we would prefer.

Mr. PATTISON. Thank you.

Mr. ST GERMAIN. Mr. Mitchell.

Mr. MITCHELL. Mr. Miller, you have been very patient with us, and it is almost noon, but I do have two other questions, however. In the interest of time and my schedule and your schedule, I will submit those two questions to you in writing and request prompt reply.

Mr. MILLER. We will be delighted to reply promptly.

[Congressman Parren Mitchell submitted the following question in writing to Chairman Miller to be answered for the record:]

Question. On page seven, you say that the cushion provided by the discount window "facilitates implementation of a restrictive monetary policy in a period of inflation demands." What does this mean? It sounds like you want banks to obtain reserves at the discount window when you are draining reserves via open market operations? What's the point of doing something with your left hand which offsets what you're doing with your right? The philosophy you are revealing here gives me a clue as to why we have so much inflation.

[Chairman Miller subsequently furnished the following response:]

Answer. During a period of credit tightness, the availability of the discount window provides individual banks with the time needed to make orderly adjustments in their lending and investment policies. The availability of the window does not mean that total reserves will be larger than desired. Rather, it helps insure that the distribution of a given amount of total reserves supplied to the banking system is determined in part by the needs of individual banks for adjustment-type credit. This facilitates the implementation of monetary policy by minimizing the risk of severe liquidity strains and abrupt changes in lending policies by individual banks that might unsettle local depost and credit markets, and in the case of large institutions, national markets.

Mr. MITCHELL. While I do have the mike and the recognition of the Chair, I would like to comment on your candor in responding to questions. Without deprecating anyone's past performance as Chairman of the Fed, I find it very refreshing that we get answers from you within 5 minutes or less. I recall some experiences where I raised a question with a former Chairman of the Federal Reserve, and I got an answer in approximately 35 minutes, and by that time I had forgotten what the question was.

I just want to compliment you on your candor and your brevity.

Thank you, Mr. Chairman.

Mr. St Germain. Mr. Vento, I understand you have one question.

Mr. Vento. Mr. Chairman, I do have a question.

My able colleague, Mary Rose Oakar, raised a question and pointed out the large profits that would accrue to Citibank, Chase Manhattan, and so forth, under both the Fed proposal and the Stanton proposal unamended. And the answer came back something like reflecting the fact that they would pay back a significant amount in their tax burden.

I have in front of me the "Tax Analysts and Advocates," a very reputable document that talks about what the large average is for U.S. rate on worldwide income of the 10 largest banks. It is 3.6 percent. That is what we are collecting now on that.

And I wonder, in light of that and in view of that if Mr. Miller would like to consider that in terms of what the cost is of the Fed proposal or the unamended Stanton bill. I think it is very difficult for a Member such as myself, looking at budget problems and so forth that we have, and taking into consideration what the chairman of this committee and the Chairman of the Board of Governors said was the goal of what they are trying to accomplish with this bill, and then looking at what the impact is.

And I hope that the committee will continue to bring forth information like this and that each of us can modify our positions to attainment of that laudable goal.

And maybe there is a response or answer to what the effective tax rate is and what the cost impact is, but I think that it is something, certainly, that should be brought up in light of the question and in light of the large payout to these banks.

My judgment is, Mr. Miller, that they are there for the services that they receive, and they have done an analysis to determine whether or not they lose or gain more by being members of the Fed with regards to their correspondent accounts that they maintain and so forth. And I would be very happy with a brief response at this time to this point.

Mr. Miller. Congressman Vento, I am not a tax expert, as you know. It is my understanding that the estimate of the loss of revenue to the Treasury—a measure of the difference between loss in Federal Reserve earnings and potential tax recoveries as increased earnings work their way through banks—was developed jointly by our staff and by the Treasury Department, and that the Treasury Department is in agreement with the figures.

And so, I have accepted their estimates as being the ones——

Mr. Vento. Do I understand your figure as being the highest tax rate, 48 percent?

Mr. Miller. The figure takes account of the corporate tax rate on banks, plus the fact that there would be an expected increase in personal income from dividend payouts. I am not an expert on this, but I understand it came out——

Mr. Vento. We end up with that 48 percent figure being tossed around a lot, but the effective rate on capital gains is about 18 percent. That is what it is, in reality. And hardly anyone pays that 48 percent. And what the worldwide rate is, the U.S. rate in worldwide income, is 3.6 percent on the various banks right today, so that is the rate they are going to be paying.

Mr. MILLER. No; you have to be careful with that reasoning. A bank may be paying a low rate based upon foreign tax credits. Any marginal income would be taxed at the 48-percent rate. On an additional dollar of U.S. income, the bank would not pay 3.6 percent; it would pay 48 cents.

You have to remember that quite often those calculations are complex. The addition of income to a bank that is paying whatever rate is taxed at the marginal rate of 48 cents on the dollar.

Mr. VENTO. That assumes that they are not going to increase expenses that they will not have any other means of writing off.

Mr. MILLER. They would deduct those in any case.

Mr. VENTO. Well, of course, they do. But if they have the income, they also have the option to do what they choose with it, and not just declare it as excess profit. They can build; they can go into a variety of things in terms of tax credits. There is a whole myriad of ways that they can move. I mean, if you assume that they are static, yes; then, of course, they are not going to do anything. But I assume they are not static, that they are thinking, that they are investing their money, and, as a consequence, they are going to be paying what they are paying, in essence, today, or one-tenth of a percent difference.

Thank you.

Mr. ST GERMAIN. Mr. Miller, I would like to wind up——

Mr. MILLER. I was just passed a note, so that I do not mislead you. I was talking about corporate tax rates, but my staff tells me that the average marginal tax rate on banks in the United States is 35 percent. I was using the corporate rate of 48 percent.

Mr. VENTO. I think I used the 48 percent, and not the chairman.

Mr. ST GERMAIN. I would suggest sometime looking at the Philadelphia Fed study that occurred about 3 or 4 or maybe 5 years ago on what banks actually indeed pay in taxes. It is very interesting.

I would like to wind up with this question. On page 10, you made reference to the fact that many problems would arise if a correspondent bank, a large one, experienced substantial operating difficulties with liquidity problems. Now, this is conceivably the case.

However, I do not think that the legislation before us would deal with that in any manner, and we, I think, can agree that the risk of a large correspondent bank having difficulties does, indeed, exist today.

I am wondering, by putting that in your testimony—I am trying to word this very nicely for you—were you suggesting in a very subtle manner that we should prohibit private clearing banks? It seems to me that would be the only way to solve the problems that you point up on page 10.

Mr. MILLER. Mr. Chairman, my point in the testimony was that we are seeing more and more larger banks leave the System, and that as we begin to see large banks leave the System there are more and more instances where clearing by a nonmember—without the same access to the window as a member—could be a problem.

I anticipated no other legislation addressed to your question, but was merely pointing out that if we continue to lose large banks, we will have more and more possibility of difficulty. That was my sole point.

Mr. St Germain. Also, I hope that your staff took note of the fact that—and I am sorry Mr. Mattox is not here—but Mr. Wylie brought up the amendment to the rather substantial piece of legislation that we will be getting to the floor in the near future, and there were no hearings on it. An amendment was introduced on a particular day, and it was held in abeyance for a little further work to be done on it.

We did receive a communication from the Comptroller's Office, but we did not receive anything from the Fed, to the best of my recollection. So, you might well want to look at that.

Mr. Miller. Yes; I think we would want to look at that.

Mr. St Germain. Mr. Chairman, the staff is a very excellent staff, and they could keep feeding me questions from now until 5 p.m. this evening, but I have some appointments to meet, and I am sure that you would welcome a break at this point.

I, too, want to echo the sentiments of many of the members, No. 1, on the success with which you have taken over the enormous duties as Chairman of the Federal Reserve Board. Of course, I am doubly happy about that, due to the fact that we come from the same area of this great country, and, of course, you are transplanted, but we think of you as a Rhode Islander.

But also, I want to compliment you on the manner in which you have handled the questions this morning, because really and truly, it is unbelieveable that we are able to wind up at this time of day, considering the fact that a great many members did, indeed, participate.

So, I want to thank you, and I am sure there will be quite a few members who will be submitting some additional questions in writing.

Mr. Miller. Mr. Chairman, I appreciate your courtesy this morning. The attendance was rather exciting, from my point of view. Many members did come and participate; I thank you, and I thank them.

Mr. St Germain. Thank you.

The full committee will be in recess until Monday, July 31, 1978, in this same room.

[Whereupon, at 12:05 p.m., the committee was adjourned, to reconvene at 9 a.m., on Monday, July 31, 1978.]

MONETARY CONTROL AND THE MEMBERSHIP PROBLEM

MONDAY, JULY 31, 1978

HOUSE OF REPRESENTATIVES,
COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS,
Washington, D.C.

The committee met, pursuant to notice, at 10 a.m., in room 2128, Rayburn House Office Building, Hon. Henry S. Reuss (chairman of the committee) presiding.

Present: Representatives Reuss, Moorhead, Annunzio, Mitchell, Derrick, Hannaford, Pattison, Vento, Stanton, Grassley, Fenwick, and Steers.

Mr. MITCHELL. This hearing will now come to order. Good morning, ladies and gentlemen.

Today we continue our hearings on the efficiency of monetary control and Federal Reserve membership. We have before us three bills and an amendment to one of these bills: H.R. 13476, H.R. 13477, Federal Reserve proposals submitted by request; H.R. 12706, the Stanton bill; and an amendment to the Stanton bill.

Our witnesses today will be:

Ray Campbell, president, Oberlin Savings Bank, representing the Independent Bankers Association; Gov. Philip E. Coldwell, Board of Governors, Federal Reserve System; Beryl W. Sprinkel, executive vice president and economist, Harris Trust & Savings; Richard D. Hill, chairman, First National Bank, Boston, representing the Association of Reserve City Bankers; and, Frank Morris, president, Boston Federal Reserve Bank.

Gentlemen, welcome.

Before proceeding, I will ask if any of my colleagues have an opening statement. There appears to be none.

For convenience, I think it would be well to divide today's witnesses into two panels. I am going to ask Mr. Campbell and Mr. Hill to serve on our first panel. We will hear from Mr. Campbell and then from Mr. Hill. Then we will proceed to question both of you at the same time, if that is satisfactory.

Governor Coldwell, Mr. Morris, and Mr. Sprinkel will then be our second panel. I understand you have a Board meeting, Governor, and we will try to put you on first on the second panel. We are anxious to hear from all of you. We are most grateful that you could be here.

I wish to note that we have received a statement from Milton Friedman, professor of economics at the University of Chicago and senior research fellow, Hoover Institution, at Stanford University, on the questions before the committee today. Among other considerations, Professor Friedman supports elimination of the Federal Reserve discretion both in fixing reserve requirements and in fixing the discount rate, on the grounds that these are "clumsy and unpredictable instruments of monetary policy." I ask that his statement be included in the record at this point.

[Professor Friedman's statement follows:]

STATEMENT ON H.R. 12706 AND OTHER LEGISLATIVE MATTERS

SUBMITTED BY

MILTON FRIEDMAN

PROFESSOR ECONOMICS, THE UNIVERSITY OF CHICAGO

SENIOR RESEARCH FELLOW, HOOVER INSTITUTION,
STANFORD UNIVERSITY

TO

COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS
U. S. HOUSE OF REPRESENTATIVES

JULY 24, 1978

I strongly support in principle four basic reforms incorporated in H.R. 12706 and the proposed amendment thereto. However, I regard them as seriously incomplete unless accompanied by a fifth reform, namely elimination of the prohibition of the payment of interest on demand deposits. In addition, I differ somewhat with respect to the best way to institute some of the reforms. I shall consider in turn each of the five reforms -- two proposed in H.R. 12706, the one that needs to be added, and the two proposed in the amendment to H.R. 12706.

A. H.R. 12706

1. Pricing of services rendered by Federal Reserve Banks. This is highly desirable in order to promote the efficient use of such services and to prevent the waste that arises from the absence of specific charges for them. It is desirable also to eliminate a special subsidy that is now being granted to member banks

of an amount not directly subject to Congressional control. The specific provisions as incorporated in H.R. 12706 seem well designed to achieve the desired objective.

2. Payment of Interest on Reserves. This is a long overdue reform. The present system in effect imposes a special tax on banks that are members of the Federal Reserve System by requiring them to lend funds at a zero interest rate to the Federal Reserve Banks and thereby indirectly to the U. S. Government. If it is desired to levy a tax on member banks, that should be done explicitly by Congress, not implicitly by the Federal Reserve System, and the rate of tax should be determined by the Congress, not by either the discretion of the Fed in setting reserve requirements, or the accidents of the market in determining the interest yield sacrificed on reserves. Moreover, it is hard to see any justification for a discriminatory tax on member banks.

In combination with pricing of services by the Fed, the payment of interest on reserves could eliminate both the subsidy and the taxes now implicitly arising from Federal Reserve actions and from the vagaries of the market.

However, the specific provision of neither H.R. 12706 nor the proposed amendment thereto with respect to the payment of interest would eliminate Federal Reserve imposed taxation. To achieve that objective, the rate of interest paid on reserves should be set by statute equal to the level specified by H.R. 12706 as a maximum, namely, the average rate paid during the preceding calendar quarter on U.S. Treasury bills with maturities of three months.

If it is desired to raise revenue from a tax on banks, that should be done via explicit tax legislation imposing a tax on all banks, not simply member banks.

B. The Missing Reform

3. Payment of Interest on Demand Deposits. The preceding two reforms would replace the present net tax on member banks with a net subsidy -- exchanging one evil for another -- unless they are accompanied by removal of the present legal prohibition of the payment of interest on demand deposits. Remove that prohibition, and competition will force banks to pass on the interest they receive on reserves to depositors.

Removal of the prohibition of interest on demand deposits is urgently called for by other considerations as well. Few legal provisions have done as much harm to the efficient operation of both the financial system and monetary policy as this one. Had interest all along been payable at competitive rates on demand deposits, there would have been no massive shift back and forth from time to demand deposits, no proliferation of indirect methods of paying interest on demand deposits, no development of NOW and POW and COW accounts. Much of the needless dispute among commercial banks and thrift institutions would have been eliminated. The monetary aggregates would have retained a more consistent meaning and would have been more useful for monetary policy.

Competition and the ingenuity of the market have made the prohibition almost meaningless, and nearly the final blow will be struck by the Federal Reserve regulatory change due to go into effect on November 1 of this year.

It is long past time to remove this major obstacle to an efficient financial system and to effective monetary control.

C. Proposed Amendment to H.R. 12706

4. Statutory Reserve Requirements. I strongly approve the elimination of Federal Reserve discretion in fixing reserve requirements. Changes in reserve requirements are a clumsy and unpredictable instrument of monetary policy.

However, the proposed schedule of requirements seems to me undesirable. What is called for is a fixed percentage requirement on deposits, the same for all banks, all amounts of deposits, all kinds of deposits, whether so-called transactions deposits or time or savings deposits. Differential requirements simply introduce unnecessary random variations into the relation between total reserves available and the total money supply as a result of shifts of deposits between different banks and different categories of deposits. With interest paid on reserves, as proposed in point 2, and on deposits, as proposed in point 3, a uniform reserve requirement is strictly neutral among banks and depositors. It performs the one function of serving monetary policy by enabling the Fed to control the quantity of money more accurately.

5. Discount Rate Linked to Market Rate. I strongly approve also the elimination of Federal Reserve discretion in fixing the discount rate. This, too, has been a clumsy and unpredictable instrument of monetary policy. It would be far better to let it be determined by the market.

As Congressman Reuss said in his statement to the House of July 14, 1978, "Monetary policy can be conducted exclusively through open market operations and discounting" -- and I would add, without discounting as well. The record of failure by the Federal Reserve in controlling the money supply -- its record of swinging widely from one extreme to the other, of not achieving its own stated targets, of permitting sharp and erratic movements from week to week and month to month -- none of this derives from the absence of the necessary knowledge, or of insufficient power on its part, or of lack of information about non member institutions. These are all excuses not reasons. As I have argued in a recent Newsweek column (appended hereto), the Fed's failure derives from its unwillingness to adapt its procedures to its changed objectives -- a striking example of the law of bureaucratic inertia.

In conclusion, I wish to commend the Committee for its far-sighted proposals, and for holding these hearings, as well as for the constructive steps it has taken earlier, ranging from Concurrent Resolution 133 to its recent communication to the Fed with respect to lagged reserve requirements.

By Milton Friedman

Inertia and the Fed

Every large bureaucracy, government or private, is certain that the way it conducts its affairs is the only way that they can be conducted.

In government, this universal truth is effectively challenged only at a time of real crisis—when something simply must be done differently. In business, the bottom line of profit provides a far more effective and frequent challenge. Business bureaucrats who insist on operating in accordance with this belief lose their jobs. That is a much-neglected advantage of the private market. Government bureaucrats may be just as perceptive as private entrepreneurs, just as wise, just as innovative in deciding what projects to undertake, but there is no mechanism for terminating unsuccessful experiments; instead, they tend to be expanded to bury small failures in a large failure. A private business that undertakes an unsuccessful experiment has no choice: it recognizes its mistake or goes bankrupt—unless it can get government to subsidize it. That is why the *loss* component of the *profit* and *loss* system is far more important than the profit component.

THE IRS VS. WITHHOLDING

I was first impressed by the law of bureaucratic inertia during World War II, when, as a junior bureaucrat in the U.S. Treasury Department, I helped to devise a system to collect income taxes at source. My wife has still not forgiven me for participating in that project.

We consulted German refugees who knew the German tax system. They described in detail their method of withholding at source and assured us that it was the only feasible way. We consulted British experts. They assured us that the very different method followed in Britain was the only feasible way. We decided that both were models of what to avoid, not to imitate.

If today you were to ask a high Internal Revenue Service official whether income taxes could be collected without a withholding system, he would consign you to the loony bin. But in 1942, when we were devising our system, the IRS was the chief obstacle to its adoption. Its bureaucrats insisted that the way they were collecting the income tax was the only feasible way; that we were starry-eyed theorists to suppose that withholding at source was administratively feasible.

My longest continuous experience with the law of bureaucratic inertia has been with the Federal Reserve System: as a monetary historian, a constant critic, an occasional consultant and participant in meetings of members of the board with academic advisers, a member of a system committee, a teacher some of whose students have worked at the Fed, and a close personal friend—and, I may say, admirer—of many high system officials.

NO ADMISSION OF ERRORS

In its 65-year history, to the best of my knowledge, the Federal Reserve Board has never admitted error in any official statement—though some courageous officials at regional banks have done so. Doubtless there are exceptions—perhaps Sen. William Proxmire should establish a Golden Purse award for authors of such admissions. Changes in policy and procedure have of course occurred—mostly as a result of crisis pressures from outside; occasionally, of changes in personnel; even more rarely, of cumulative self-generated change growing out of the work of the board's own able professional staff or the able professional staffs at some of the regional banks.

In three decades of personal involvement with the system, I have often written, or sent memorandums, to the chairman or other members of the board suggesting changes in policy, regulations or procedure. Every reply, even when it was personal and not a form letter, defended current procedure and explained why my suggestions were impractical. Requests from Congressional committees or individual congressmen asking the system to comment on testimony I had given to the committee or on one of my published articles have uniformly elicited cleverly written briefs for the defense, never admitting any mistake, never accepting any suggestion, explaining all adverse developments as resulting from forces outside the system's control, and selecting from available evidence only those items supporting the system's position.

In 1970, it was suggested to the board that it appoint two committees of outside experts: one, on the measurement of the monetary aggregates, which had been coming under increasing criticism for inaccuracy; the other, on alternative methods of controlling the monetary aggregates. The first committee, of which I was a member, was finally appointed four years later. We turned in our final report two years ago. Our recommendations have not yet been implemented!

The second expert committee was never appointed, even though the Fed's failure to modernize its operating procedure is little short of a disgrace. A decade ago, under enormous pressure, the Fed shifted its intermediate policy target from primary stress on "money-market conditions" (i.e., interest rates) to primary stress on the growth of monetary aggregates. This shift was strongly reinforced by Congressional Concurrent Resolution 133 in 1975 (since incorporated in the Federal Reserve Act), requiring the Fed to report quarterly to Congress its targets for the growth in monetary aggregates for the coming year.

STICKING TO OBSOLETE METHODS

Yet, despite internal committees that have been established to examine the Fed's operating procedures, those procedures are still the same as the ones that were developed to control "money-market conditions." Most economists specializing in money and banking agree that those procedures, however well adapted for the earlier purpose, are poorly adapted to control monetary aggregates. Their continued use explains the highly erratic behavior of monetary aggregates from week to week, and the tendency for the growth rate of monetary aggregates to swing from one extreme to the other.

An alternative operating procedure has been subject to extensive study and research, is entirely feasible administratively—indeed much simpler than the present procedure—and has been recommended to, and by, Congressional committees. I am confident that it would be regarded as superior to the present procedure for controlling monetary aggregates not only by outside experts but by a majority of economists on the research staffs of the Federal Reserve Board and its regional banks. Yet, in a decade, not the slightest step has been taken to move to this alternative technique. On the contrary, the Fed has adopted a series of measures that have made the present procedure even less effective.

We have a new chairman at the Fed. He comes from the business world where the bottom line has forced him to fight the law of bureaucratic inertia. Will that background enable him to do so also in government? Or will he, like his predecessors, become a captive of and spokesman for the bureaucracy he supposedly commands?

Mr. MITCHELL. The Chair wishes to thank the chairman of the full committee for permitting me to chair the hearings last week and this morning. However, I do have to make an apology. The Budget Committee on which I also serve has a meeting scheduled at 10:30. a.m. At that time I will turn the Chair over to the chairman of the full committee, Chairman Reuss.

Gentlemen, thank you very much, and let us start with Mr. Campbell and Mr. Hill, to lead off.

STATEMENT OF RAYMOND D. CAMPBELL, PRESIDENT, OBERLIN SAVINGS BANK, OBERLIN, OHIO, FIRST VICE PRESIDENT, INDEPENDENT BANKERS ASSOCIATION OF AMERICA, REPRESENTING THE ASSOCIATION, ACCOMPANIED BY RICHARD PETERSON, CHIEF LEGISLATIVE COUNSEL

Mr. CAMPBELL. Thank you, Mr. Mitchell.

Chairman Reuss, members of the committee, my name is Raymond D. Campbell. I am first vice president of the Independent Bankers Association of America—IBAA—and president of the Oberlin Savings Bank Co., Oberlin, Ohio. With me is Richard Peterson, our chief legislative counsel.

Our association appreciates the opportunity to testify on this legislation. However, I should point out that the constraints imposed by the timing of these hearings has limited our ability to assess fully the effects of these proposals. Therefore, I should like you to view our comments as first impressions.

We share the concern of the Federal Reserve Board's Chairman that attrition of both banks and attrition of membership in the Federal Reserve System has accelerated in recent years, and that the failure to halt membership attrition may have severe implications for the Federal Reserve Board to conduct monetary policy.

However, we are not persuaded that legislative remedies proposed by the Federal Reserve Board will provide the necessary inducements to attract nonmembers to join the Federal Reserve System or persuade members to remain in the System.

Let me turn, then, to specifics.

First, H.R. 13476 is in effect a mandatory universal statute requiring commercial banks, mutual savings banks, savings and loan associations, and credit unions to maintain reserves at Federal Reserve banks against demand deposits and all other transaction accounts.

IBAA has long been opposed to legislation which would make it mandatory for all banks to maintain reserves in the Federal Reserve System. Although national banks comprise about 27 percent of IBAA's membership, 73 percent are State-chartered banks, of which a small minority are members of the Fed. State-chartered banks favor the freedom to join or not to join the Federal Reserve System.

Furthermore, the exemption purportedly provided for the first $5 million in transaction accounts is purely illusory in that there is broad statutory authority given the Board to impose reserves on even these deposits.

Another proposal in this package of legislation is H.R. 13477, which would authorize the payment of interest on reserve balances held in any Federal Reserve bank.

The cost to the U.S. Treasury of such interest payments could be a very high price to pay to induce State-chartered depository institutions to become members of the Federal Reserve System.

On the other hand, a strong case has not been made to demonstrate that the payment of interest on reserves as proposed will in fact solve the problem of attrition.

Since the purpose of the payment of interest on reserves held at the Fed is to make Fed membership more attractive and halt membership attrition, the amount of income derived from such payment would have to be equal to or exceed the earnings on reserves presently available under the State reserve regulations.

A recent study of the burden of Fed membership revealed that the heaviest burden is borne by member banks with deposits under $100 million, and that banks with deposits over $1 billion appear to experience a net benefit from System membership.

Thus, smaller member banks may operate at a competitive disadvantage relative to the larger ones.

This suggests that unless interest payments on reserves are equated with the burden of membership, interest payments are not likely to be an effective instrument to attract new members or in reducing membership attrition.

A backdrop to the proposed legislation is the prospect of paying for Fed services.

The regulatory proposal to make explicit charges for Fed services could create problems for smal banks; that is, those with assets of $50 million or less.

Most of these banks would be exempt from the reserve requirements, and presumably under our reading of the statute would not be receiving any interest payment from the Fed. However, they, as members, would be assessed charges for services provided by the Fed.

Under these circumstances, small banks are not likely to be attracted to membership in the Fed since they would probably opt for obtaining these services through their correspondent banks. Fed services may be attractive, but if a bank can obtain all of those services plus many more from its correspondent, it would be sacrificing earnings to be in the System.

The only unique service offered by the Fed is access to the discount window, but a large number of banks have found that this service is not an adequate inducement to remain members.

The thrust of the proposed legislation appears to be directed at holding in the Federal Reserve System the 1,003 State-chartered members of the System and inducing the remaining 8,600 State-chartered nonmember banks to join the System.

Most nonmember State-chartered banks are relatively small institutions as revealed by the fact that in 1976 there were 11,800 banks with assets under $50 million accounting for 82 percent of all banks in the United States.

If, as some studies have shown, small banks bear a heavier burden of Fed membership than larger banks, the inducements offered to the smaller banks to join or retain membership in the Fed should take account of these differences of membership burden. We do not believe the proposed legislation meets this requirement.

Turning next to H.R. 12706, which would provide for the pricing of Federal Reserve System services and the payment of interest on reserves, we believe the bill attempts to give sufficient study to the proposal before putting it into effect. Of course, this implicitly precludes any prospect of explicit pricing until the studies are concluded.

While authorizing the Fed to pay interest on reserves, the bill requires the Board to prepare a feasibility study and transmit it to Congress not later than July 1, 1981. We believe this is a constructive approach.

H.R. 12706 will hamstring the Fed in pricing services by mandating explicit pricing to include both direct and indirect costs. This could make membership very unattractive, especially if the Fed could not respond to market pressures caused by other correspondents providing like services.

The proposed amendments to H.R. 12706 seek to address some of the concerns we have identified above.

First, by reducing the amount of interest to be paid to income and earnings, there would be no drain on the U.S. Treasury.

Second, there would be no universal reserve requirements imposed on nonmember banks, and there would be a statutory exemption of the first $10 million in transactions accounts, both consistent with the goal of reducing the burdens of membership and enhancing the competitive posture of small independent banks.

Third, a universal reporting requirement would be imposed to provide current reliable information in order to effectuate monetary policy.

We question whether or not an enhancement of the current reporting program involving nonmember banks will provide all the information necessary without imposing a new regulatory paperwork burden on small banks.

On the other hand, we believe more attention needs to be given to the proposed amendments which wrenches from the Fed the flexibility to set reserve requirements and the discount rate.

On balance, we cannot endorse any of the bills proposed under consideration since we are not convinced that they will achieve the stated objectives.

Furthermore, we are not convinced that such legislation is necessary to prevent System attrition or that the Fed's ability to manage monetary policy requires that all depository institutions maintain reserves in the Fed.

To improve the Fed's capability to manage monetary policy it may only be necessary to authorize it to obtain summary statistics on assets and liabilities of all depository institutions as proposed in an amendment to the Stanton bill.

Another proposal which warrants consideration short of the sweeping proposal of the Fed is that offered by the board of directors of the Federal Reserve Bank of Kansas City.

This proposal would allow member banks to invest a portion of their required reserves in Government securities owned by the Federal Reserve. Individual banks would be allowed to choose specific issues from the variety of maturities in the Federal Reserve's portfolio of U.S. Government securities.

All purchases and sales of securities for reserve purposes would be made with the Federal Reserve at money market prices. The securities would be held by the Federal Reserve in a safekeeping account maintained for reserve purposes. The proposed amendment requiring a feasibility study of such a proposal seems appropriate.

Another proposal suggested the creation of a new type of affiliated membership, which would make membership more attractive, particularly to smaller banks, by reducing some of the burdens of membership.

Under this proposal the requirement to purchase stock in the Fed would be eliminated; access to the discount window would be provided at a rate above that charged full members; and the reserves required would be based on a clearing formula but not above those requirements for members.

If Congress is concerned that the Fed may take precipitous action in the event no legislation passes before the end of the session, the answer to us is to pass a resolution putting this first on next year's agenda while prohibiting any implementation.

There will be time to have the Congress, the Fed and all the various interest groups analyze the impacts and identify unreasonable courses of action.

We believe that if the Fed is sincere in enhancing membership, there is one free way to do it.

Over the years many members of our association have gotten the impression that there is a deep-seated Fed prejudice against small independent banks. These prejudices have been manifested in a number of ways.

In a study done by this very committee it is clear, for instance, that the boards of the district banks are heavily weighted in favor of individuals sensitized to big banks rather than small banks.

Furthermore, a historical review of the administration of the Bank Holding Company Act suggests a nonrecognition of the importance of this corporate structure as a means of transferring bank ownership. In short, you can catch more flies with honey than with vinegar.

If there is any message that we urge on the members of the committee today, it is to go slow.

Certainly it is appealing to many of our member banks to receive interest on reserves. Yet a concern of the unknown, pricing, suggests caution.

If the Congress would seek to enhance membership rather than just give the Fed the tools necessary to effectuate monetary policy, all the costs should be known. We have not seen the specific proposals, and we understand the committee has not, either.

If a package of proposals will achieve the result, they should all be carefully studied, not rushed through. The vast majority of our member banks are the purported beneficiary of these proposals. They have not had a chance to understand what has been proposed, much less respond to either us or the committee directly.

In all fairness, they need the chance to reflect and we urge you to give them that opportunity.

Our doubts as to the effectiveness of the proposed legislation in meeting the attrition problem are heightened by the facts revealed in a study analyzing Federal Reserve System attrition since 1960.

That study found the principal factors contributing to Fed attrition to be a tendency of de novo banks to remain outside the System, and a pattern of more mergers and absorptions of member banks than nonmembers with most of the merged and absorbed banks having been acquired by other member banks.

The bulk of deposit attrition has been due to a more rapid rate of internal deposit growth on the part of the nonmember sector, including the growth of de novo nonmember banks chartered since 1960, resulting in a relative increase in the average size of nonmember banks.

The study concluded that without any reduction in the burden of Fed membership, the pattern of net system withdrawals, as well as the preference of de novo banks for nonmember status, may be expected to continue.

Moreover, recent withdrawals of member bank subsidiaries by several multibank holding companies portend increased withdrawal activity on the part of multibank holding companies.

Given the large size of multibank holding company member banks, such an increase in withdrawal activity could mean a further acceleration of deposit attrition.

To slow and possibly turn around the pace of aggregate deposit attrition, the burden of System membership, according to the study, must not only be eliminated but must be converted to a net benefit in order to encourage both ongoing nonmembers and de novo banks to join the System.

Our analysis of the proposed legislation leads us to the conclusion that it will not meet this test.

Thank you.

[The prepared statement of Mr. Campbell, on behalf of the Independent Bankers Association of America, follows:]

STATEMENT OF THE

INDEPENDENT BANKERS ASSOCIATION OF AMERICA

ON

H.R. 13476, THE RESERVE REQUIREMENTS ACT OF 1978

H.R. 13477, THE INTEREST ON RESERVES ACT OF 1978

H.R. 12706, THE FEDERAL RESERVE MEMBERSHIP ACT OF 1978

BEFORE THE

COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS

OF THE

HOUSE OF REPRESENTATIVES

JULY 31, 1978

Mr. Chairman, my name is Raymond D. Campbell. I am first vice president of the Independent Bankers Association of America, and president of the Oberlin Savings Bank Company, Oberlin, Ohio.

I appreciate the opportunity to appear before this Committee on behalf of the 7,300 members of IBAA to present our views on the proposals relating to the payment of interest on reserves held by the Federal Reserve banks and the explicit pricing of Federal Reserve System services.

IBAA is comprised of a large number of relatively small community banks. More than 80 percent of our banks have assets of $25 million or less and over two-thirds are located in towns of under 5,000 population. Most of our members are found in the middle third of the country comprising the major agricultural states, consequently our banks are deeply involved in meeting the credit needs of agriculture, small business, rural housing and the consumer. In 1976, for example, commercial banks with assets of $25 million or less supplied almost half the credit extended to agriculture by all of the nation's commercial banks. Thus, by supplying a major share of bank credit to rural communities, our banks make a considerably larger contribution to the nation's economic well-being than their size and share of commercial banking assets might suggest.

We appreciate the opportunity to testify on the proposed legislation to enable the Federal Reserve Board to pay interest on reserves held at Federal Reserve Banks and to sanction the payment of explicit charges rendered depository institutions by the Federal

Reserve System. However, I should point out that the constraints imposed by the timing of these hearings has limited our ability to assess fully the effectiveness of these proposals in stemming the attrition of Federal Reserve System membership and their impact on the banks comprising our membership. Therefore, I should like you to view our comments as first impressions.

We share the concern of the Federal Reserve Board's chairman that attrition of both banks and deposits of membership in the Federal Reserve System has accelerated in recent years and that the failure to halt membership attrition may have severe implications for the ability of the Federal Reserve Board to conduct monetary policy. However, we are not persuaded that legislative remedies proposed by the Federal Reserve Board will provide the necessary inducements to attract non-members to join the Federal Reserve System or persuade members to remain in the system.

Let me turn, then, to the specific pieces of legislation being considered by this Committee. The first proposed bill, H.R. 13476, would amend the Federal Reserve Act to provide for the maintenance of reserves against transaction accounts in Federal Reserve Banks by all federally insured depository institutions. It is, in effect, a mandatory universal reserves statute requiring commercial banks, mutual savings banks, savings and loan associations and credit unions to maintain reserves at Federal Reserve Banks against demand deposits and all other transaction accounts.

The bill would exempt from the reserve requirements, subject to such rules and regulations as may be adopted by the Board, the first $5 million of transaction accounts of a depository institution. Reserves meeting the statute's requirements are to be in the form of balances in the Federal Reserve bank of which it is a member or at which it maintains an account; or balances maintained by a non-member depository institution in a member bank or in a Federal Home Loan Bank maintaining such funds in the form of balances in a Federal Reserve bank of which it is a member or at which it maintains an account.

IBAA has long been opposed to legislation which would make it mandatory for all banks to maintain reserves in the Federal Reserve System. Although national banks comprise about 27 percent of IBAA's membership, 73 percent are state chartered banks, of which a small minority are members of the Fed. State chartered banks favor the freedom to join or not to join the Federal Reserve System. Furthermore, the exemption purportedly provided for the first $5 million in transaction accounts is purely illusory in that there is broad statutory authority given the Board to impose reserves on even these deposits. It is our deep concern that the mandatory reserve requirement would superimpose federal regulation over state chartered depository institutions and so erode state regulation as to ultimately lead to complete federal control.

Another proposal in this package of legislation is H.R. 13477, which would authorize the payment of interest on reserve balances held in any Federal Reserve bank. It would authorize the Federal

Reserve banks to pay a total amount of interest in any one year up to the sum of: (a) total receipts from the recipients of such interest for services rendered by Federal Reserve banks; and (b) 7 percent of the total net earnings of the Federal Reserve banks computed without regard to the payment of such interest; but with a ceiling rate of 2 percent per annum on reserve balances in excess of $25 million. As to the latter (b), the Board is now seeking deletion of this section. The cost to the U.S. Treasury of such interest payments could be a very high price to pay to induce state chartered depository institutions to become members of the Federal Reserve System. There is no assurance that the rate of interest to be paid on reserves will constitute sufficient inducement for non-member institutions to join the Fed or to enjoin Fed members from defecting. A strong case has not been made to demonstrate that the payment of interest on reserves as proposed will, in fact, solve the problem of attrition.

Since the purpose of the payment of interest on reserves held at the Fed is to make Fed membership more attractive and halt membership attrition, the amount of income derived from such payment would have to be equal to or exceed the earnings on reserves presently available under state reserve regulations. A recent study of the burden of Fed membership revealed that the heaviest burden is borne by member banks with deposits under $100 million and that banks with deposits over $1 billion appear to experience a net benefit from system membership. Thus smaller member banks may operate at a competitive disadvantage relative to the larger ones.[1/] This suggest that unless interest payments on reserves are equated with the burden of membership, interest payments are not likely to be an effective instrument to attract new mem-

1 Robert E. Knight, "Comparative Burdens of Federal Reserve Member and Nonmember Banks", Monthly Review, Federal Reserve Bank of Kansas City, March 1977, p.27.

bers or in reducing membership attrition.

The lack of precise data on the net costs of this proposal to the Treasury leads us to urge caution in setting the permissible interest rate limits too high. On the other hand, the setting of rates of return on reserves too low would make membership unattractive and thus defeat one of the basic purposes of the legislation.

A backdrop to the proposed legislation is the prospect of paying for Fed services. The regulatory proposal to make explicit charges for Fed services could create problems for small member banks, i.e., those with assets of $50 million or less. Most of these banks would be exempt from the reserve requirements and presumably, under our reading of the statute, would not be receiving any interest payment from the Fed. However, they as members would be assessed charges for services provided by the Fed. Under these circumstances small banks are not likely to be attracted to membership in the Fed since they would probably opt for obtaining these services through their correspondent banks. Fed services may be attractive but if a bank can obtain all of those services plus many more from its correspondent it would be sacrificing earnings to be in the system.[2/] The only unique service offered by the Fed is access to the discount window but a large number of banks have found that this service is not an adequate inducement to remain members.

The effect of the payment of service charges on small banks is difficult to predict since it cannot be determined whether they would continue to obtain most of these services through their correspondent banks as an offset against compensating balances or

[2] Ronald D. Watson, Donald A. Leonaid, Nariman Behravesh, "The Decision to Withdraw: A Study of Why Banks Leave the Federal Reserve System," Federal Reserve Bank of Philadelphia, Research Paper No. 30, Sept. 1977.

whether the correspondent banks would pass these explicit charges through to their respondents in addition to the income earned on compensating balances. It seems certain that correspodent banks would be likely to adjust their compensating balance requirements upward to pass through some of the explicit charges assessed against them by the Fed for services. Thus small banks are not likely to obtain any benefits from the payment of interest on reserves but could be required to pay more for services performed by the Fed.

The thrust of the proposed legislation appears to be directed at holding in the Federal Reserve System the 1,003 state chartered members of the system and inducing the remaining 8,600 state chartered non-member banks to join the system. Most non-member state chartered banks are relatively small institutions as revealed by the fact that in 1976 there were 11,800 banks with assets under $50 million accounting for 82 percent of all banks in the U.S. If, as some studies have shown, small banks bear a heavier burden of Fed membership than larger banks, the inducements offered to the smaller banks to join or retain membership in the Fed should take account of these differences of membership burden. We do not believe the proposed legislation meets this requirement.

Turning next to H.R. 12706, which would provide for the pricing of Federal Reserve System services and the payment of interest on reserves we believe the bill attempts to give sufficient study to the proposal before putting it into effect - of course this implicitly precludes any prospect of explicit pricing until the studies are concluded.

While authorizing the Fed to pay interest on reserves the bill requires the Board to prepare a feasibility study and transmit it to Congress not later than July 1, 1981. We believe this is a contructive approach.

H.R. 12706 will hamstring the Fed in pricing services by mandating explicit pricing to include both direct and indirect costs. This could make membership very unattractive, especially if the Fed could not respond to market pressures caused by other correspondents providing like services.

The proposed amendments to H.R. 12706 seek to address some of the concerns we have identified above. First, by reducing the amount of interest to be paid to income and earnings, there would be no drain on the U.S. Treasury. Second, there would be no universal reserve requirements imposed on non-member banks, and there would be a statutory exemption of the first $10 million in transactions accounts, both consistent with the goal of reducing the burdens of membership and enhancing the competitive posture of small independent banks. Third, a universal reporting requirement would be imposed to provide current and reliable information in order to effectuate monetary policy. We question whether or not an enhancement of the current reporting program involving non-member banks will provide all the information necessary without imposing a new regulatory paperwork burden on small banks.

On the other hand, we believe more attention needs be given to the proposed amendments which wrenches from the Fed the flexability to set reserve requirements and the discount rate.

Indeed, the proposals before this committee are a mixed bag of monumental import.

On balance we cannot endorse any of the bills proposed under consideration since we are not convinced that they will acheive the stated objectives. Furthermore, we are not convinced that such legislation is necessary to prevent system attrition or that the Fed's ability to manage monetary policy requires that all depository institutions maintain reserves in the Fed. To improve the Fed's capability to manage monetary policy it may only be necessary to authorize it to obtain summary statistics on assets and liabilities of all depository institutions as proposed in an amendment to the Stanton bill. Another proposal, short of the sweeping proposal of the Fed which warrants consideration, is that offered by the Board of Directors of the Federal Reserve Bank of Kansas City. This proposal would allow member banks to invest a portion of their required reserves in government securities owned by the Federal Reserve. Individual banks would be allowed to choose specific issues from the variety of maturties in the Federal Reserve's portfolio of U.S. government securities. All purchases and sales of securities for reserve purposes would be made with the Federal Reserve at money market prices. The securities would be held by the Federal Reserve in a safekeeping account maintained for reserve purposes. 3/ The proposed amendment requiring a feasibility study of such a proposal seems appropriate.

Another proposal suggested the creation of a new type of "affiliated" membership, which would make membership more attractive

3 "A proposal for Enhancing the Attractiveness of Membership in the Federal Reserve System." A report by the Board of Directors of the Federal Reserve Bank of Kansas City, June 1977.

particularly to smaller banks, by reducing some of the burdens of membership. Under this proposal the requirement to purchase stock in the Fed would be eliminated; access to the discount window would be provided at a rate above that charged full members; and the reserves required would be based in a clearing formula but not above those requirements for members.

At this juncture we feel that the point and counterpoint that seems to be rushing this legislation along ought to be resisted. We feel the issues have been blurred and the net losers will be those who are intended as beneficiaries. Important questions need be asked such as whether the immediate goal is to enhance Fed membership or to provide the Fed with the tools necessary to effectuate monetary policy. Some of the proposals seem to be at cross purposes. In short, what is the rush?

If Congress is concerned that the Fed may take precipitous action in the event no legislation passes before the end of the session, the answer to us is to pass a resolution putting this first on next year's agenda while prohibiting any implementation. There will be time to have the Congress, the Fed and all the various interest groups analyze the impacts and identify unreasonable courses of action.

We believe that if the Fed is sincere in enhancing membership, there is one free way to do it. Over the year many members of our Association have gotten the impression that there is a deep seated Fed prejudice against small independent banks. These prejudices have been manifested in a number of ways. In a study done by this very committee it is clear, for instance, that the boards of the district banks are heavily weighted in favor of individuals sensitized to big banks, rather than small banks. Furthermore, historical review of the administration of the bank holding company act suggests a nonrecognition of the importance of this corporate structure as a means of transferring bank ownership. In short, you can catch more flies with honey than with vinegar.

If there is any message that we urge on the members of the committee today, it is to go slow. Certainly, it is appealing to many of our member banks to receive interest on reserves. Yet a concern of the unknown--pricing--suggests caution. If the Congress would seek to enhance membership rather than just give the Fed the tools necessary to effectuate monetary policy, all the costs should be known. We have not seen the specific proposals, and we understand the committee has not either. If a package of proposals will achieve the result, they should all be carefully studied--not rushed through. The vast majority of our member banks are the purported beneficiary of these proposals. They have not had a chance to understand what has been proposed much less respond to either us or the committee directly. In all fairness, they need the chance to reflect and we urge you to give them that opportunity.

Our doubts as to the efficacy of the proposed legislation in meeting the attrition problem is heightened by the facts revealed in a study analyzing Federal Reserve System attrition since 1960. That study found the principal factors contributing to Fed attrition to be a tendency of _de novo_ banks to remain outside the system; and a pattern of more mergers and absorptions of member banks than non-members with most of the merged and absorbed banks having been acquired by other member banks. The bulk of deposit attrition has been due to a more rapid rate of internal deposit growth on the part of the non-member sector (including the growth of de novo non-member banks chartered since 1960), resulting in a relative increase in the average size of non-member banks.

The study concluded that without any reduction in the burden of Fed membership, the pattern of net system withdrawals, as well as the preference of de novo banks for non-member status, may be expected to continue. Moreover, recent withdrawals of member bank subsidiaries by several multi-bank holding companies portend increased withdrawal activity on the part of multibank holding companies. Given the larger size of multibank holding company member banks, such an increase in withdrawal activity could mean a further acceleration of deposit attrition. To slow and possibly turn around the pace of aggregate deposit attrition the burden of System membership according to the study must not only be eliminated but must be converted to a net benefit in order to encourage both on-going non-members and de novo banks to join the System.[4/] Our analysis of the proposed legislation leads us to the conclusion that it will not meet this test.

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4. John T. Rose, An Analysis of Federal Reserve System Attrition Since 1960, Federal Reserve Board Staff Economic Study, December 1977.

Mr. MITCHELL. Thank you very much. Mr. Hill.

STATEMENT OF RICHARD D. HILL, PRESIDENT, ASSOCIATION OF RESERVE CITY BANKERS, CHAIRMAN, THE FIRST NATIONAL BANK OF BOSTON

Mr. HILL. Thank you.

Mr. Chairman, members of the committee, I appreciate this opportunity to present my views to your distinguished committee on three questions which you have posed in connection with your examination of the membership problem within the Federal Reserve System.

The Association of Reserve City Bankers was organized in 1913, shortly after the passage of the legislation which established the Federal Reserve System. Its membership is comprised of nearly 400 executive officers from over 160 banks located in the principal cities of the United States, usually called reserve cities.

The vast majority of our members are members of the Federal Reserve System, and they all conduct a correspondent banking business.

While I believe my views are reasonably representative of those of a majority of the members of our association, you should understand that contrary to the popular perception of bankers as possessing herd instincts, they are, indeed, difficult to corral on legislative matters.

The first question has to do with the need for membership in the System. We all agree that the membership base is eroding, but is this truly harmful to the public interest?

The Governors of the Federal Reserve Board believe that this erosion of membership hampers the exercise of monetary policy and I think we all agree that the proper exercise of monetary policy is an indispensable portion of their responsibilities.

Learned economists disagree among themselves as to the relationship between member bank reserve balances and control over the money stock. Some say there is none, some attribute a partial relationship and others consider it essential.

These same economists, incidentally, express widely different opinions with respect to the effects of monetary policy on the country's economy and, of course, they rarely achieve a consensus with respect to the actions of the Open Market Committee.

I take comfort in the historic record of general stability in the banking system since the establishment of the Federal Reserve System compared to that which existed before. This leads me to place a high value on the purpose and structure of this institution which, with all its faults, has served us well.

The structure is based upon widespread membership of commercial banks accounting for a major share of transaction deposits and upon the exercise of monetary policy through their reserve balances.

Therefore, I conclude with utter simplicity that until we be ready to reexamine the entire purpose and structure of the System, and this would take several years, we should be deeply concerned with the erosion of membership and should try to arrest it.

There is, of course, another important aspect to the membership problem, and that has to do with the availability of the discount window. Small- and medium-sized banks having decided to leave the System are able to obtain lines of credit from correspondent banks but they are assured of their correspondent's ability to obtain their liquidity, if needed, from the lender of the last resort—namely, a Federal Reserve bank.

There are ways for loans to be made to nonmembers, but these are at higher rates and somewhat cumbersome as they require a vote of the Board of Governors. The ghost of Federal loans or guarantees of Lockheed and the city of New York may well hover over these decisions whereas member bank access to the discount window is usually quite routine.

My comments on explicit charges for Federal Reserve services and on the pricing of these services are based on the following conclusions:

One, consideration of pricing should only be made after a decision has been reached on interest on reserve balances. To charge member banks for Federal Reserve services without offsetting the cost burden of holding non-interest-bearing reserves would only heighten the problem of membership.

Two, as a matter of principle, it should be unnecessary for the Federal Government or any agency thereof to compete with the private sector unless the private sector is unable or unwilling to provide an essential service to society.

Three, the principle of unbundling costs and benefits is sound in that it eliminates the subsidization of any economic activity. It allows benefits and prices to flow in an objective and equitable basis and in the long run allows the free market to function properly.

Four, the services to be priced are those presently being offered by the System; namely, check collection, currency and coin, wire transfer, noncash collection and safekeeping of securities.

The Federal Reserve should price its services on a full cost basis, including variable costs, fixed costs and overhead costs as well as a reasonable return on capital, and there should be a complete description and cost for each service.

In pricing the check service, consideration must be given to not only price but also the availability of funds. The Federal Reserve should not allow the further creation of float by giving availability; that is, investable funds before they have received good funds from the paying bank.

The payments systems today—by that I mean the check system as well as currency and coin—functions either through the correspondent bank network or through the Federal Reserve System with a great deal of interaction between the two.

It allows users to choose between institutions offering these services to enable them to maximize their benefits in the payments system. That choice should remain.

Obviously there will be an impact on the correspondent banking system and bankers presently offering these services for cash or demand deposit balances will be affected in varying degrees.

However, we are a resourceful industry and we have had many years of experience meeting competition and adjusting our services quickly to the needs of our customers.

In other words, we do not fear this threatened competition except to the extent that prices are subsidized to levels below those set in free competition among the market participants.

It must be obvious from these remarks that it will be difficult to rally widespread support from our members for the Federal Reserve proposals under discussion until the pricing policies are clearly enunciated and understood.

In general, however, we support the principal of unbundling and of separating the benefits from the costs.

Finally, I have been asked to comment on the proposal to pay interest to member banks on required reserves. This is, of course, the key to the solution of the membership problem and is an issue which should have been resolved many years ago when the apparent cost to the Treasury would have been de minimis and the consequent political difficulty much less an obstacle than it is today.

In effect, the marketplace has overtaken the inequilibrium in our central banking system and more and more banks are turning to their other choice; namely, a more economically feasible State system.

Congress could stop this by fiat but again the political realities surrounding our dual banking system will make this difficult, if not impossible.

Bankers have long urged recognition by the Board of the equity of paying for reserves which, after all, are valuable deposits on which the Federal Reserve earns a great deal of money.

They have felt—and still do—that inasmuch as the reserves are based upon their own liabilities, most of which they solicited from customers by their own efforts, they should have the economic reward accruing on them instead of paying it as an extra tax for the right to conduct a banking business.

While we very much support the principle advanced in the Federal Reserve proposal we have to say that the suggested stratification of interest to be paid—namely, a market rate on the first $25 million of required reserves and a much, much lower rate on the excess—is a concession to politics rather than to the equity of the matter.

Studies conducted for the Federal Reserve System seem to say that the cost of membership weighs more heavily on the small banks than on the larger ones, and this is the published rationale for favoring the former in the allocation of interest payments.

Part of the argument was based upon a mistaken idea that in accepting demand deposits from respondent banks in payment for services, there was a residue of these deposits over and beyond the amount necessary to provide adequate compensation to the correspondent.

In today's competitive market, this is simply not so. In fact, the accounts are often inadequate.

A recent study just completed by Prof. George Bentson, of the University of Rochester, which shortly will be available to this committee, rather strongly refutes the premise of a proportionally greater burden of membership on the smaller banks.

I do, therefore, urge the Congress to give heed to the fairness doctrine in deciding how to allocate the interest payments.

Thank you for permitting me to make these observations on behalf of the association which I represent. I will be happy to answer any questions within the scope of my limited knowledge of this sometimes abstruse subject.

[Mr. Hills' prepared statement, on behalf of the Association of Reserve City Bankers, follows:]

PREPARED STATEMENT OF RICHARD D. HILL

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The first question has to do with the need for membership in the System. We all agree that the membership base is eroding--but is this truly harmful to the public interest?

The Governors of the Federal Reserve Board believe that this erosion of membership hampers the exercise of monetary policy and I think we all agree that the proper excercise of monetary policy is an indispensible portion of their responsibilities. Learned economists disagree among themselves as to the relationship between member bank reserve balances and control over the money stock. Some say there is none, some attribute a partial relationship and others consider it essential. These same economists, incidentally, express widely different opinions with respect to the effects of monetary policy on the country's economy and, of course, they rarely achieve a concensus with respect to the actions of the Open Market Committee.

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There is, of course, another important aspect to the membership problem and that has to do with the availability of the discount window. Small and medium-sized banks having decided to leave the System are able to obtain lines of credit from correspondent banks but they are assured of their correspondent's ability to obtain their liquidity, if needed, from the lender of last resort, namely a Federal Reserve Bank. There are ways for loans to be made to non-members but these are at higher rates and somewhat cumbersome as they require a vote of the Board of Governors. The ghost of Federal loans or guarantees of Lockheed and the City of New York nay well hover over these decisions whereas member bank access to the discount window is usually quite routine.

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2. As a matter of principal, it should be unnecessary for the Federal government or any agency thereof to compete with the private sector unless the private sector is unable or unwilling to provide an essential service to society.
3. The principal of unbundling costs and benefits is sound in that it eliminates the subsidization of any economic activity. It allows benefits and prices to flow in an objective and equitable basis and in the long run allows the free market to function properly.
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The payments system today, by that I mean the check system as well as currency and coin, functions either through the correspondent bank network or through the Federal Reserve System with a great deal of interaction between the two. It allows users to choose between institutions offering these services to enable them to maximize their benefits in the payments system. That choice should remain.

Obviously there will be an impact on the correspondent banking system and bankers presently offering these services for cash or demand deposit balances will be affected in varying degrees. However, we are a resourceful industry and we have had many years of experience meeting competition and adjusting our services quickly to the needs of our customers. In other words we do not fear this threatened competition except to the extent that prices are subsidized to levels below those set in free competition among the market participants. It must be obvious from these remarks that it will be difficult to rally widespread support from our members for the Federal Reserve proposals under discussion until the pricing policies are clearly enunciated and understood.

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Finally, I have been asked to comment on the proposal to pay interest to member banks on required reserves. This is, of course, the key to the solution of the membership problem and is an issue which should have been resolved many years ago when the apparent cost to the Treasury would have been de minimis and the consequent political difficulty much less an obstacle than it is today. In effect the market place has overtaken the inequilibrium in our central banking system and more and more banks are turning to their other choice, namely a more economically feasible state system. Congress could stop this by fiat but again the political realities surrounding our dual banking system will make this difficult, if not impossible. Bankers have long urged recognition by the Board of the equity of paying for reserves which, after all, are valuable deposits on which the Federal Reserve earns a great deal of money. They have felt--and still do--that inasmuch as the reserves are based upon their own liabilities, most of which they solicited from customers by their own efforts, they should have the economic reward accruing on them instead of paying it as an extra tax for the right to conduct a banking business.

While we very much support the principle advanced in the Federal Reserve proposal we have to say that the suggested stratification of interest to be paid, namely a market rate on the first $25 million of required reserves and a much, much lower rate on the excess is a concession to politics rather than to the equity of the matter. Studies conducted for the Federal Reserve System seem to say that the cost of membership weighs more heavily on the small banks than on the larger ones, and this is the published rationale for favoring the former in the allocation of interest payments. Part of the argument was based upon a mistaken idea that in accepting demand deposits from respondent banks in payment for services, there was a residue of these deposits over and beyond the amount necessary to provide adequate compensation to the correspondent. In today's competitive market this is simply not so, in fact, the accounts are often inadequate. A recent study just completed by Professor George Benston, of the University of Rochester, which shortly will be available to this Committee, rather strongly refutes the premise of a proportionally greater burden of membership on the smaller banks.

I do, therefore, urge the Congress to give heed to the fairness doctrine in deciding how to allocate the interest payments.

Thank you for permitting me to make these observations on behalf of the Association which I represent and I will be happy to answer any questions within the scope of my limited knowledge of this sometimes abstruse subject.

The Chairman. Thank you very much, Mr. Hill.

This concludes the testimony from this panel.

Mr. Moorhead?

Mr. Moorhead. Thank you, Mr. Chairman.

It seems to me that from this testimony, a clear point of difference seems to emerge. Mr. Campbell says the burden of membership in the Fed weighs more heavily on the small banks than on the large ones. Whereas, Mr. Hill, you seem to challenge that statement.

How can you rationalize your differences and explain them? I must say that at first blush, since the larger banks tend to have a higher membership percentagewise than the smaller banks, the layman's view would favor Mr. Campbell's conclusion.

I would like to be educated further on that.

Mr. Hill. In view of the fact that it is the large banks that are still largely in the System, I will answer it first.

The larger banks are really captives to the System, Mr. Moorhead. Those who offer correspondent banking services really need entry to the Federal Reserve System in order to provide entry for their customers.

Furthermore, quite a number of the large banks historically were national banks, who must be members. There is a great deal of imagery resistance in giving up a national bank charter.

There is also in some States possibly a concern about the quality of State banking regulations which the large bank would be inheriting.

Mr. Moorhead. Gentlemen, let us make the assumption, with which you may not agree, but just for purposes of argument, that it would be good national policy—I am not talking about independent bankers or reserve city bankers—but good national policy to discourage the attrition of membership and to encourage membership.

Making that assumption, what would you recommend? I know, Mr. Campbell, you said one clear one was the negative attitude of the Fed toward the smaller banks. That is a little hard to legislate, but I would think possibly larger membership might achieve that result. Maybe that is the chicken-or-egg argument.

But what concrete proposals would each of you make from possibly different vantage points? What would induce smaller banks to enter the System? What would discourage larger State-chartered banks from withdrawing from the System?

We can start with you, Mr. Campbell.

Mr. Campbell. The primary reason, Mr. Moorhead, that small banks do not belong to the Fed is because of the cost of membership. That is the primary reason.

If some type of structure can be put together whereby a bank could be compensated and have a net benefit through a system of payment of interest on reserve balances and explicit charging, I think that membership would gain in the Fed.

I happen to be a State-member bank. I recognize that there are costs involved with that membership. However, we have maintained our membership in the Fed because we believe that we do derive benefit from the association that we have.

The Federal Reserve Bank in Cleveland, and the people at that particular Fed, have been very cooperative. They understand our special needs. They have been very helpful over the years. For those reasons, Oberlin Savings Bank has not withdrawn.

Mr. MOORHEAD. Mr. Hill?

Mr. HILL. Mr. Moorhead, I believe the reason is, as Mr. Campbell says, purely an economic one. There is a clear bottom line choice for the middle-sized to larger banks which are in a position to withdraw from the System.

Under the State systems they are able to keep their reserve balances, either with correspondent banks, for which they receive services, or in U.S. Government obligations on which they receive a full market rate of interest.

In the Reserve System, of course, there are none of these benefits except that we do get all of our check handling, wire transfer services and coin handling services, for nothing.

The difference between the market value of interest on our reserves and the cost of the services rendered by the Fed is fairly substantial. It may be for every $100 of cost of services we are giving up $200 in interest payments. So, there is a $100 differential there.

So, it seems to me that the clearest way to stop this attrition is to recognize the monetary value of those reserves, which at one time was quite small, to recognize the value of this and pay it.

I very strongly support that aspect of the solution to this problem.

Mr. PETERSON. Mr. Moorhead, I think that one of the difficulties that we have tried to address in our testimony relates to the matter of pricing and the confusing studies that have been done. There have been quite a few of them in the last 3 years—on where burdens lie, what kind of pricing will do what, how much interest is required to compensate for general charges—go right back to our central point.

We don't want to buy a pig in a poke. That is the problem in answering your question.

Mr. MOORHEAD. My time has expired. When it comes around again, I may ask you about whether we address that question you posed, whether we actually need membership in the Federal Reserve System, Mr. Hill.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you.

Mr. Stanton?

Mr. STANTON. Thank you very much, Mr. Chairman.

Gentlemen, I wish to welcome you here. I appreciate your cooperation with the committee on this very important subject.

Mr. Chairman, I would be remiss—we always do traditionally—if I didn't extend a special welcome, as is my prerogative, to my friend from Oberlin, from the great State of Ohio, Mr. Campbell.

No reflection, Mr. Hill, but we are neighbors, to a degree, in the suburbs of Cleveland, although Mr. Campbell is in a little bit different direction from Cleveland than I am. But we are very happy to have you here.

Mr. CAMPBELL. Thank you, Mr. Stanton.

Mr. STANTON. I think Mr. Moorhead asked philosophically an interesting question that I will not wait until we get back to him to ask you both.

Just how important, forgetting about the position of the independent bankers and the Reserve bankers, is the Federal Reserve System to our country?

This idea of membership, is it worth fighting for or is it not? Is it not possible that the Fed could affect monetary policy without any members at all, or a significantly lower number of members?

Do you think it is an important subject matter that we are now conducting these hearings on; that is, the loss of membership in the Fed? Is it worth saving, or are we wasting our time? I would like to have general comments from both of you on that.

Mr. CAMPBELL. Mr. Stanton, Mr. Chairman, we certainly feel that it is worth saving. Even though we do not borrow from the discount windows, we always react to discount window changes because our community is a well-read community, being a collage community, and our people in our community know immediately when there has been a change in the discount rates.

They do react in their buying habits. They look at the overall economy very carefully. I think that the Fed has a very, very, definite responsibility in monetary policy.

However, I could not evaluate how far down in numbers in Fed members we could go without the Fed being affected. But I certainly think that we could be reaching too low in Fed membership if that is necessary.

Mr. STANTON. Mr. Hill.

Mr. HILL. I agree very much with that. Obviously the primary job of the Fed is to conduct monetary policy and—the Fed believes it would be hampered by loss of membership.

As I said in my testimony, you could get a whole range of arguments from learned economists. It is a very abstruse series of arguments. Some say there is no connection between membership, reserves, and monetary policy. Others say there is a partial connection. Others say it is a very tight connection, and very necessary.

I believe that because of the stability that has existed in our banking system since the formation of the Federal Reserve System, that it would be unwise to tamper with this unless we conduct a detailed study of the purposes and structure of the Federal Reserve System, and that this would take several years to do properly.

In the meantime, the ship is shinking. So, we probably should plug the hole for the time being.

Second, the existence of the discount window is very important. We saw this demonstrated during a few crises which took place during the recession, and we also saw how these crises were met very promptly without loss to depositors.

Third, the Federal Reserve does play an extremely important part in the whole payments system. Admittedly, they have competitors: namely, correspondent banks.

But there are a great many services provided, not unlike the Rural Electrification Administration, which provides electricity to areas which the utilities simply cannot handle economically.

This is the same with the Fed payments system. They provide a great many services—check handling, clearing services—to areas which economically cannot be received by the private sector.

They also are in the forefront of helping to design new systems for the future. The Federal Reserve had a great deal to do with the establishment of automated clearing houses, which is a beginning of a reduction in the paperbased system, working toward the eventual elimination of checks with their tremendous economic cost.

So, I think in these areas that the Fed is extremely important to our system, and I draw the simplistic conclusion from that that we do need membership to support it.

Mr. STANTON. One last question this time around, Mr. Hill. This question is asked basically because of your location within our country.

The problem, you know, has accelerated in recent years, of the drop of membership in the Fed. Of course, your area of New England has led this exodus. In fact, to an alarmingly so rate within the last year, and especially as we get into those banks of $100 million and over.

The question comes up that we have not seen anything yet compared to what is going to happen, that there has been, due to this legislation or talk of possible legislation, a holding back of present members leaving the System, until we do see how we do come out.

Is this a prevalent attitude, in your opinion, of many members, now members of the System who perhaps are holding back, and who if we have no legislation at all, or we pass over this subject for the time being, will be leaving the System?

Mr. HILL. I believe from things I have heard in the New England area that there are several more banks giving serious consideration to leaving and that possibly they are being persuaded to hold off until Congress makes up its mind as to how to solve the problem.

The reason, perhaps, for the larger exodus in New England was that amazing compromise which was achieved for paying interest on checking accounts, which, as you recall, was confined to Massachusetts and Vermont as an experiment.

This created a severe economic hardship on a number of banks—the transition did—and caused them to reexamine their bottom lines very carefully.

Also, I think it is fair to say that because New England has not achieved the growth of much of the rest of the country, because of its mature economy, the recession bore much more heavily on the New England banks. Levels of loan losses were considerably higher, and that had an impact on earnings as well.

Mr. STANTON. Thank you.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Mr. Stanton.

Mr. Annunzio.

Mr. ANNUNZIO. Thank you, Mr. Chairman.

Mr. Hill, you know, this proposition of the Federal Reserve Board losing membership is nothing new in this country. Labor unions are losing membership. Fraternal organizations, among the great ethnics of this country—we can't get the young people interested in joining these old line fraternal organizations. They are just not joiners.

Now, as you know, the national banks are members of the Federal Reserve System. What the Federal Reserve is attempting to do is to increase their membership in the Federal Reserve System by getting these State banks to join their System. As I see this thing, they are holding out some carrots to pay interest rates.

I am chairman of the Consumer Affairs Subcommittee. Will you tell me, Mr. Hill, in the first place, why all these banks have to be members of the Federal Reserve System? I don't see the importance of that at all.

And tell me, by paying interest rates on deposits to national banks—and I know in my own State of Illinois most of the other banks, correspondent banks, have an affiliation with larger banks—how does the consumer fare in all this?

Every time we do something in Government it costs you, as a consumer, money. It costs me money. We are notorious for that. How is the consumer going to come out?

Mr. HILL. Mr. Annunzio, if our premise is correct, that the Federal Reserve is doing a good job or is supposed to be doing a good job in helping to stem inflation in our country, and if membership is required to help them do this, then I think it is a primary benefit to the consumer, to have a central banking system, which can make its proper contribution toward stability in our prices.

Mr. ANNUNZIO. Pardon me. You said membership is required?

Mr. HILL. Membership, as you know, sir, is required only for national banks.

Mr. ANNUNZIO. National banks, right.

Mr. HILL. But there are many State banks which are members of the Federal Reserve System.

Mr. ANNUNZIO. Right.

Mr. HILL. But it is purely voluntary.

Mr. ANNUNZIO. Right.

Mr. HILL. What I am saying is that I believe if the erosion of membership which is taking place now is going to hamper the exercise of monetary policy on the part of the Fed—therefore, it should be our total concern to try to stop that, so that the Fed can exercise its major responsibility.

Mr. ANNUNZIO. Will you explain to me, on the erosion of membership, how we are going to stop this? You are talking now about a closed shop membership.

I can see the day will come to Congress when we will have to have a relief for these bankers who object to the closed shop.

Mr. HILL. No, sir.

Mr. ANNUNZIO. We are voting all the time here on labor unions.

Mr. HILL. This would still be voluntary. This simply holds out a carrot to those who are considering leaving membership, or to those who are not in it.

Mr. ANNUNZIO. Let us talk about that carrot. What is that going to cost the consumers?

I am going to vote on this. I am not the banker and the expert. You are going to teach me today. You are going to tell me why I should vote to give the Fed the authority to sign up these banks who are not members of the Federal Reserve System.

How is that going to benefit the consumer? It will benefit the Federal Reserve. They will have more banks. But how is that going to benefit the American public? How is that going to benefit the taxpayers?

Is it going to wind up costing them more money? These are the answers I must have if we pass this legislation, I must go back to my district.

Anything as extensive as banking will reflect on the members of this committee first. Convince me as a member of this committee why I should wind up signing myself as an organizer now for the Federal Reserve System. That is what I am doing.

Mr. Hill. First, Mr. Annunzio, there should be relatively little economic effect on the banks that are now in the State system and decide to join the Fed.

What this is attempting to do is equalize the economic benefits between the cost of being in the Fed and the cost of being in the State system.

So, this would simply have the effect of holding the present members so no more would leave. How many new ones would be attracted I cannot say.

Mr. Annunzio. What happens to the correspondent banks now?

Mr. Hill. The correspondent banks, which I represent, will be affected by this bill. They will be affected if the Federal Reserve prices its services below the market price—we are going to lose correspondent banks who will say we will use the services of the Fed instead of your services.

So, it will affect us. But that is a factor of pricing and competition. All we ask is that the Fed prices recognize the same economic factors that ours do, and that is our cost of doing business.

Mr. Annunzio. My time has expired, Mr. Hill. Thank you.

Thank you, Mr. Chairman.

The Chairman. Thank you, Mr. Annunzio.

Mr. Hyde of Chicago.

Mr. Hyde. Thank you, Mr. Chairman.

Mr. Campbell, what is the impact of the reduction in reserve requirements proposed by the Fed? Do small banks find it attractive? If not, why not?

Mr. Campbell. We could find that reduction attractive, Mr. Hyde. But we still cannot accept a proposal without knowing more about the pricing of the services that will accompany this change. We are most concerned about the explicit pricing.

Mr. Hyde. Does your position reflect the sentiment of all the small banks, Fed members and nonmembers, as far as you know?

Mr. Campbell. Again, Mr. Hyde, this legislation is new. We haven't had an opportunity really to determine what the feeling of our members across the Nation might be.

Mr. Hyde. How much time do you think that would take, to get a good feeling or a good reaction from your members?

Mr. Campbell. We would think that it would be April of next year before we could have any conclusive answer.

Mr. Hyde. Thank you. I have no further questions.

The Chairman. Mr. Derrick?

Mr. Derrick. Thank you, Mr. Chairman.

Mr. Hill, what part of the erosion do you feel could be attributable to the situation where a large bank chooses to remain in a holding company, subsidiaries drop out, and the large bank enjoys the services of the Fed, while also passing that on to the subsidaries?

Mr. Hill. Well, this has been taking place. Some bank holding companies with one or two large members in the System——

Mr. Derrick. We are aware that it has.

Mr. Hill [continuing]. Have caused their subsidiaries——

Mr. Derrick. What effect do you feel it might have on the erosion of membership?

Mr. Hill. I think that is very much a part of the reason, but their decision is a purely economic one.

Mr. Derrick. I understand that. What they are doing is getting a free ride, so to speak.

Mr. Hill. No; the lead bank is the member of the Fed, and is paying a heavy price for Fed membership, and then is charging for its services.

Mr. Derrick. Would not the total cost to all of those banks within the holding company be much greater than the price that the one large bank would be paying?

Mr. Hill. If they were all members, yes.

Mr. Derrick. So that would be a loss to the Fed. It is certainly a loss in membership.

Mr. Hill. That is right.

Mr. Derrick. Do you have any suggestions as to what might be done to cure this?

Mr. Hill. Mr. Derrick, I think the suggestions that are before us—namely, interest on reserves and specific pricing—would solve that problem. I don't think that kind of a problem should be solved by fiat or by law.

I don't think the law should be passed saying that bank holding companies must not allow their banks to leave the Federal Reserve System.

Mr. Derrick. You think that it should be economically advantageous——

Mr. Hill. I think it should be a free market decision.

Mr. Derrick. Thank you very much.

Mr. Campbell, I don't understand your reasoning in that you feel that the Fed can manage monetary policy just as well with a decreasing membership, or that it is not necessary for membership, the participation of their reserves.

I happen to think that the Fed serves a tremendous purpose, as a counterbalance with the Congress in making economic policy.

I go to Mr. Annunzio's question, and I appreciated Mr. Hill's response because certainly the consumer, all of us, would be at a great disadvantage if we did not have this counterbalance, in my opinion.

I don't see how you can—would you enlighten me?

Mr. Campbell. Mr. Derrick, I did not intend to say that I felt that we could operate without monetary control from the Fed. We do think it is important. I did state earlier that I had no way to evaluate how far in reduced membership we can go without the Fed losing control although it seems to be getting to be a more serious problem.

Mr. Derrick. On page 8, you say:

> Furthermore, we are not convinced that such legislation is necessary to prevent System attrition or that the Fed's ability to manage monetary policy requires that all depository institutions maintain reserves in the Fed.

I understand that you put "all" in there, but where do you put——

Mr. Campbell. We are referring to this specific legislation, Mr. Derrick. We would be concerned about a tremendous decrease in Fed membership and in the dollars which they control through the Fed System.

Mr. Derrick. But do you agree, then, that the larger membership does give the Fed a more direct impact on monetary policy?

Mr. Campbell. I would agree; yes.

Mr. Derrick. And that erosion would cut back that impact?

Mr. Campbell. Certainly the erosion could be serious, but we are not convinced that this legislation is the practical way to approach that problem.

Mr. Derrick. So it is not a question of whether membership has the impact; it is just the manner in which you approach it, that you disagree with?

Mr. Campbell. That is correct, especially from the standpoint of rushing into these corrections. We feel there should be a delay period for additional study.

Mr. Derrick. I have never found this committee to rush into anything. So I think you can rest easy on that.

Mr. Peterson. Mr. Derrick, I think we have gone over——

The Chairman. Would the witness identify himself?

Mr. Peterson. I am Richard Peterson, legislative counsel of IBA.

We have gone over the studies, going one way or another, as to whether membership attrition really has an impact on the ability of the Board, the Open Market Committee, and the Federal Reserve bank presidents to manage monetary policy. Almarin Philips and his brethren say that membership does not, while a number of others say that it does.

I do think, though, that we are in agreement with a statement that, I believe, was made by Chairman Burns last year that the real problem at the Fed is a political one. In short, should membership attrition proceed at a much faster pace, cause unhealthy deterioration in this counterbalance that you were talking about. So we certainly look at it as a political problem.

Mr. Derrick. I thank you very much.

Mr. Hill, you referred to several economists with varying opinions on this matter. I have not had the advantage of seeing their views. Would you furnish them?

Mr. Hill. I will try to. You may be asking for trouble because there is an awful lot of it.

Mr. Derrick. Well, that is all right, I will look at it just the same. Thank you.

Has my time expired?

The Chairman. Your time is up. Thank you, Mr. Derrick.

Mr. Hannaford.

Mr. Hannaford. Mr. Chairman, I regret that I was not here for the statements, and I have just one brief question.

H.R. 13477 proposes to pay interest on reserves. Is it not true that this legislation would benefit the large banks that are not dissatisfied with the Fed and would not do very much good for the smaller banks, and therefore perhaps would miss the mark which is the intended purpose of this legislation.

Mr. Hill, would you respond?

Mr. HILL. One of my complaints in my own testimony, Mr. Hannaford, was that the proposal as offered by the Federal Reserve System, that is the payment of market rates of interest on the first $25 million worth of reserves, and a 2-percent rate on the remainder, favors the small banks as opposed to the large banks, and that I believe that the burden of membership lies equally on both the large banks and the small banks.

So I think that the legislation, the various bits and pieces of the legislation, suggestions we have before us, basically do favor the small banks, proportionately more than they do the large banks.

Mr. HANNAFORD. I have no further questions, Mr. Chairman.

The CHAIRMAN. Thank you, Mr. Hannaford.

Mr. Grassley.

Mr. GRASSLEY. Thank you Mr. Chairman.

I, too, want to echo the words of Mr. Stanton and say we appreciate your coming out on this Monday morning to testify and give us your judgments on these important bills that are before us.

I want to start out by asking Mr. Hill, referring to a statement on page 4 of his testimony. On the fourth line from the bottom, you say:

> In other words, we do not fear this threatened competition except to the extent that prices are subsidized to levels below those set in free competition among the market participants.

I appreciated what you say and probably everybody else does. What the bankers in the private sector fear from the Federal Reserve is that there will be subsidization, or cross subsidization of some of the services in the Federal Reserve to a point where they will be priced so low as to be unfair competition to the private sector?

Mr. HILL. That is precisely correct, Mr. Grassley.

Mr. GRASSLEY. Well then, maybe I misunderstood that sentence. I assumed that you fear that the pricing between the correspondent banks and the smaller banks is going to be such that there will not be any business for the Federal Reserve. That is not what you are saying here?

Mr. HILL. No. What I am saying is that we recognize that the Federal Reserve, in effect, is in competition now with the correspondent banking services that we offer, and we have, I think, competed effectively with them over the years. If they start pricing for the services, which we do—we charge our correspondents explicit prices for the services we provide—if the Federal Reserve institutes a pricing system which is substantially below their costs of doing this business, then we think it would be unfair competition. We could be priced out of business.

Mr. GRASSLEY. OK.

Mr. HILL. We do not think any government agency should offer services that can be offered by the free enterprise systems on a subsidized basis below the cost of production.

Mr. GRASSLEY. OK. Then we are in agreement on that position. This leads me to this question: From your perspective then, do you see that we have the ability to determine, in a very finite way, what certain costs are in the Federal Reserve System so that we can in fact price them so that they are competitive and do not undercut private service fees so that we do not have an accounting problem as we do with, for instance, the Postal Service? In the Postal Service, first-class mail is probably subsidizing fourth-class mail and basically it is because the Postal System says that they cannot really account for a lot of their overhead so that they can categorize just exactly what the costs are for first-class mail versus fourth-class mail. We do not want to get into that same problem with the Federal Reserve.

Do you think their accounting system is such that they will be able to delineate those costs?

Mr. HILL. Yes, I think they can. In the first place. you have to remember there is a large body of banks in the private sector now offering these services and we have finally, it has taken us a long time, but we have finally learned how to determine our own costs. So I think we know almost down to a single check how much it costs us to handle these transactions. Therefore, we could very quickly spot any attempt on the part of the Fed to seriously subsidize these costs because we think we know their costs reasonably well. We know the costs of computers; the systems do not vary widely.

I think where our differences of opinion would come would be on assigning the capital costs of the Fed to these transactions. We have to assign them to our own transactions. That is a difficult part, but we know how much it costs them to operate, we know what their direct costs are.

Mr. GRASSLEY. Therein may be a problem and an excuse that would lead to cross subsidization, though not intended, and it probably will not even be very visible. Is that a possibility?

Mr. HILL. That is a possibility, but I think you will have available very many panels of objectors in the private banking system who understand the costs.

Mr. GRASSLEY. Let me suggest to you that Thursday Mr. Miller said in commenting on this same point that they are fast approaching that point in cost accounting at which they will be able to make a determination. But he also suggested that for a period of time, and I think it was in terms of a few years—maybe that is not fair for me to make that determination myself without going back over the testimony—but for a period of startup time there may be some costs that are not going to be quite allocable and that may be, in a sense, the start of an unintended subsidization, that it may be difficult to move away from as time passes.

Mr. HILL. Yes, that is a danger. And I recognize that if the Fed were to charge its full costs at the outset, because of their heavy capital cost, that the price they would have to charge using our system of charging could be as much as twice what we charge; there is that possibility. If they were to do that immediately, it would bring about a widespread erosion of their own staff, their check-handling staffs. I think they would like to phase that in over a longer period of time.

My concern would only be if they price their products clearly below the market level; if they price their products competitively with ours, we will be able to meet the competition.

Mr. GRASSLEY. I thank you for your comments.

My time is up, Mr. Chairman.

The CHAIRMAN. Mr. Pattison.

Mr. PATTISON. Let me follow up on that problem of pricing, because it is very interesting to me. Right now, what is the status of competition between correspondent banks?

How do you set your own prices? For instance, do you have correspondent banks who deal with you on the basis of your own prices for your services? Do banks switch around between different correspondent banks? If one correspondent bank raises its prices, is it easy for a bank to say well, your price is too high, I am going to go to bank X. Do you really have a competitive situation so that you cannot raise your prices when somebody else is charging less?

Mr. HILL. Yes. It is quite easy to change a correspondent bank relationship, and they do. We adjust our prices periodically based on our costs and a reasonable profit, and then adjust them again to the marketplace.

Mr. PATTISON. So if correspondent bank X is operating inefficiently and raises its prices to its correspondents, one of those correspondents could easily say, you have raised your prices but correspondent Y has not raised its price, so I am going to deal with correspondent Y. That obviously keeps the price in line.

How do you get a similar kind of mechanism going with the Fed when you do not have that competition; when the Fed—could we have a system, for instance, where a Fed member could say, I am not going to deal with the Fed any more. I will be a member of the Fed with explicit pricing but I will go to correspondent bank X to handle my services; I will do away with my discount window?

Mr. HILL. At some point the checks would have to enter the Federal Reserve System and go through a correspondent Federal Reserve member bank who would have to pay whatever the price may be. There are competitive systems outside the Fed.

Mr. PATTISON. I understand that. What you are saying is, everything has to go through the Fed ultimately.

Mr. HILL. For settlement purposes and a large number of checks which cannot be handled in any other way but through the direct sending route.

We can clear a large number of checks that come into our hands in Boston outside the Federal system through direct sending. Then we settle the balances between the two banks through the Federal Reserve System.

Mr. PATTISON. For that you would now under this scheme be paying some explicit charge?

Mr. HILL. Well, the charge for settlement between accounts in the Fed would be very minimal.

Mr. PATTISON. So I guess the question is, suppose the Fed became very inefficient, raises its prices, based upon its costs, based upon a good accounting system but it is very inefficient, how do you control that price? There is no competition, there is no other place to go.

Mr. HILL. Of course the Fed would offset the benefits of paying interest on deposits if they raised their prices through inefficiency well above the market price. They would wipe out the economic benefits of membership in the Fed.

Mr. PATTISON. So what you are saying is that the major device for controlling the explicit pricing for services on the basis of the Fed would be membership?

Mr. HILL. That will be a very strong factor.

Mr. PATTISON. Perhaps even stronger than their costs?

Mr. HILL. Yes.

Mr. PATTISON. And the accounting system?

Mr. HILL. We are concerned that they might use that competitively too much; in other words, subsidize the price too far below their cost of service. That is the one matter that the entire correspondent banking industry will be watching very closely.

Mr. PATTISON. Right. So you watch them closely. What do you do about it if there is no legislative requirement that they charge whatever the market is, whatever that means?

Mr. HILL. Well, I guess we are suggesting that there be some legislative requirement that their charges, prices be based on their costs, fully determined costs.

Mr. PATTISON. Thank you. I have no further questions.

The CHAIRMAN. Mrs. Fenwick.

Mrs. FENWICK. Thank you, Mr. Chairman.

I notice on page 3 you speak of "unbundling costs and benefits." Could you help me with that; unbundling the costs and benefits? I hope you did not go into it earlier when I was at another meeting.

Mr. HILL. Let me draw an analogy, Mrs. Fenwick.

The most famous unbundling example was conducted by IBM Corp.; when they sold a computer, the price of the computer involved the cost and profit to them of the computer as well as the cost of servicing the computer and providing software. When they unbundled they separated these. They said, you will pay one price for the computer and you will pay explicit prices for the services.

Mrs. FENWICK. I see.

Mr. HILL. This is what we are talking about here. It is a bit of jargon that crept into our language since IBM days.

Mrs. FENWICK. Right. Now I would like to explore a little further the carrot Mr. Annunzio referred to.

The carrot would be the interest paid on the reserve deposits, right?

Mr. HILL. Yes.

Mrs. FENWICK. As I understood Mr. Miller the other day, and if I am not correct I hope the chairman or one of my colleagues will correct me, he suggested that the Federal Reserve would pay the cost of the first few years.

Now, there are two or three things I would like to know here. Does this mean that the Federal Reserve has hundreds of millions of dollars in its account that it is not using now that it could use to subsidize these interest payments? Or does it mean that they would come out of the U.S. Treasury funds, tax funds, would therefore be a burden on the taxpayer?

How does that operate? I did not have a chance to ask him when it was my turn.

Mr. HILL. Mrs. Fenwick, there will be more qualified witnesses from the Fed to discuss this, but I believe what he meant was that because the payment of interest, net of collecting the cost of services, will reduce the earnings of the Federal Reserve System which hitherto have been passed on to the Treasury, that for some period of time the Treasury will try to ease their burden by paying out of their surplus some extra funds. In other words, they will pay a larger dividend to the Treasury than they actually earn and take it out of their surplus.

Mrs. FENWICK. In other words, you are saying then that the Federal Reserve has a surplus account in the Treasury, is that it?

Mr. HILL. No. You have to look at the Federal Reserve as a separate corporation which has its own balance sheet, assets, liabilities, capital, and surplus.

Mrs. FENWICK. Yes.

Mr. HILL. And I believe the intention is for some period of time to allow their surplus to be reduced.

Mrs. FENWICK. What I am trying to——

Mr. HILL. But these are funds not in the Treasury but funds under their own ownership.

Mrs. FENWICK. So they have a separate account. They do not, in other words, when they make money, put it into the General Treasury fund; they keep it in a separate account, is that right?

Mr. HILL. I think I will defer to a subsequent witness on the accounting at the Fed. I think——

Mrs. FENWICK. What I am trying to find out about are the several hundred millions needed to pay for the carrot, to provide the carrot Mr. Annunzio was talking about.

When they are used to pay interest to the banks, does that mean that the Treasury receipts will be lower and therefore that the deficit, unless compensated for by other tax, will be higher? Or does it mean that this will have no effect on the deficit or on the Treasury receipts because the money that the Federal Reserve gets from its member banks is kept in a separate account?

That is what I am trying to find out. Who is going to pay for all this?

Mr. HILL. Well, first the impact of this would normally be felt on the Treasury, because the Federal Reserve turns over its earnings at the end of the year to the Treasury.

Mrs. FENWICK. So therefore reduce—

Mr. HILL. I think they propose, their proposal is to have their earnings reduced by approximately 7 percent, which is somewhere between $450 and $600 million; I cannot remember the figure.

Mrs. FENWICK. Right.

Mr. HILL. And that amount of money would not be paid to the Treasury and therefore, given no other factor, would increase the budget deficit of the United States.

Mrs. FENWICK. That is what I wanted to know.

Mr. HILL. However, a portion of that, of course, would result in increased taxes paid by the banks back to the Treasury; because of higher earnings, they would pay a higher income tax.

Furthermore, a strong argument can be made that if this carrot is not held out, then as more and more banks leave the Fed, the Fed's earnings will decline and therefore the Treasury is going to lose this money anyway, as well as losing——

Mrs. FENWICK. I understand, that was very well explained by Mr. Miller.

Mr. HILL. But the last part of it, which is the way the Fed has chosen to ease the transition burden on the Treasury, using surplus funds, I would prefer to defer to Federal Reserve witnesses who are here who are far more expert than I.

Mrs. FENWICK. When you refer to surplus funds, what are you talking about; funds that they do not turn over to the Treasury? In other words, do they divide their receipts into something called surplus funds and something that goes directly to the Treasury?

Mr. HILL. Well, these are capital and surplus funds and how the surplus funds arose over the years I do not know.

Mrs. FENWICK. OK, we will have to inquire from Treasury on that. But I wondered, how would it be if instead of all these complications—with the Treasury losing money—the Federal Reserve, together with the banks, simply decided on some nationwide reserve requirements? Instead of paying interest on reserves, suppose there were uniform requirements so that banking would be sound, without costing the taxpayers anything? How about that?

Mr. HILL. Well, that would solve the problem if every bank in the United States which had transaction balances were required to keep equal reserves with the Fed. Then the problem of inequality between the State banks and nonmember banks and member banks would disappear.

I did say in my testimony, however, that I believed that politically that would be very difficult to achieve.

Mrs. FENWICK. Why?

Mr. HILL. Because of the strong feelings of those who espouse the dual banking system, the Conference of State Bank Supervisors, the State Governors. They would believe that this is removing prerogatives from State government and moving it to Federal Government.

Mrs. FENWICK. My time has expired. Thank you very much.

The CHAIRMAN. Thank you, Mrs. Fenwick. Mr. Steers.

Mr. STEERS. Mr. Hill, in answering Mr. Pattison's questions on the subject of how you price your services, you indicated you charge cost plus a reasonable profit. If the Fed offered prices at cost, how could you compete?

Mr. HILL. Mr. Steers, I believe—I think the Fed is concerned, and this is hearsay, I am not sure whether hearsay evidence is allowed—I believe that the Fed is concerned that if they priced their product at their full cost, including all of their capital costs. that they would become very noncompetitive with the banking system and that they would tend to lose even more membership.

Mr. STEERS. Do you mean because they are less efficient? Why would the Fed with its huge resources be less efficient?

Mr. HILL. I do not necessarily think they are less efficient. I really do not know, Mr. Steers, but each Federal Reserve bank does have a fairly elaborate building in each one of its reserve cities and subreserve cities, and it was a matter of policy to build these buildings in downtown urban areas, in some cases to help support the local economies rather than build an efficient. pure operating center outside in the suburbs, which many commercial banks have done.

So I think the Fed has the cost burden of those fairly large downtown buildings within their structure. Now we have them too, but we have a great many more services, including international loans, installment and wholesale loans over which we can spread those costs.

Mr. STEERS. Thank you, Mr. Chairman. That is all I have.

The CHAIRMAN. Thank you, Mr. Steers.

I just have a couple of questions.

Mr. Hill, you are chairman of the First National Bank of Boston?

Mr. HILL. That is correct.

The CHAIRMAN. When I last resided in Boston, that was a safe and sound institution and I presume it still is.

Mr. HILL. It was Friday night when I left.

The CHAIRMAN. You also speak on behalf of the Association of Reserve City Bankers?

Mr . HILL. Yes, sir.

The CHAIRMAN. Those are largely correspondent banks, are they not?

Mr. HILL. Yes, sir. It was orginally formed in 1913 for that purpose.

The CHAIRMAN. How many members do you have now?

Mr. HILL. We have about 400 members, Mr. Chairman, individual members.

The CHAIRMAN. The Governor of the Federal Reserve, Mr. Philip Coldwell, in his testimony before the U.S. Senate on May 25 of this year said, and I quote:

> This erosion of membership threatens to weaken our financial system as more and more of the Nation's payments and credit transactions are handled outside the safe channels of the Federal Reserve.

Now, do you consider you and your correspondent banking channel an unsafe channel?

Mr. HILL. No, sir. If I had——

The CHAIRMAN. Or would you take issue with the Federal Reserve on that characterization?

Mr. HILL. I would have just left out the word "safe"——

The CHAIRMAN. Well, that is Switzerland without the Alps, is it not?

Mr. HILL. I see no difference between operating the payment system within the Fed or without the Fed.

The CHAIRMAN. I should perhaps confess to something of a conflict of interest here because my father and grandfather were correspondent bankers and they were eminently safe, I can assure you of that.

Mr. HILL. As you know, I have a conflict of interest too, because I am a director of the Federal Reserve Bank of Boston this year.

The CHAIRMAN. Now, on just that point, when a member bank posts reserves with the Federal Reserve, it gets, under the present system, zero interest on those posted reserves, does it not?

Mr. HILL. That is correct.

The CHAIRMAN. When a member bank of your correspondent system posts reserves with you, you are prohibited from paying interest to him?

Mr. HILL. That is correct.

The CHAIRMAN. If the proposal to pay interest on Federal Reserve reserve-posted requirements went through, your correspondent banking system would be placed at a considerable additional competitive disadvantage, would it not?

Mr. HILL. Yes, it would be, there would be additional competition, Mr. Chairman. But we would try to offer services, efficient services, and hopefully priced properly so the correspondent bank would stay with us and would keep enough deposit balances with us to earn the services which we would provide for him.

The CHAIRMAN. Still and all, it might enter his cranium at some time to say, well, the First National Bank of Boston sure does paperwork for us nicely, but they do not pay anything on our correspondent balances and the Fed does, so we will go with the Fed.

Mr. HILL. But under the new system, the Fed would also charge for explicit services, as we do now, except we are paid for it in deposit balances.

The CHAIRMAN. True, but that is a rough equation, indeed, and the fact would remain that under the Fed's proposal, as opposed to the amendment offered by so many of the members of this committee, you, under the new dispensation, would be competing with an institution which would be allowed, indeed mandated, to collect something like 7 percent of its total receipts by way of payment of interest on reserves and disburse them to the banks and you would have no equivalent method of sweetening your pot; it that not so?

Mr. HILL. That is correct, except the 7 percent is net of payment of the services that the Fed provides.

The CHAIRMAN. Oh, surely.

Mr. HILL. And if our services are competitive with the Fed's, then we will try to keep our correspondent banks dealing through us, even though they may maintain reserves with the Fed because they will be paid fully for the reserves they keep with us in terms of services that we give them.

The CHAIRMAN. Thank you.

I have one question of Mr. Campbell, who comes here with the blessing, not only of our distinguished ranking member Mr. Stanton, but of a former Congressman, Mr. Mosher, who is a particular friend of mine and I understand is very close to you.

I must confess to a little disappointment in the testimony of the Independent Bankers Association of America. For example, the Federal Reserve's proposal, first, as you know, is for universal deposit reserves. Well, that says your tiniest member bank must plunk down a 7-percent interest fee with the Fed. Under the proposed amendment offered by so many members of this committee, and which will be considered as a perfecting amendment to the Stanton bill, independent banks are the particular darlings of that proposal.

For example, they would be exempted entirely from any reserve requirements whatsoever on their first $10 million of demand deposits. It is a fact, is it not, that the average deposit liabilities of your member banks is on the order of $10 million?

You can consult Mr. Peterson if you want.

Mr. CAMPBELL. Yes, somewhat on that order, maybe slightly more on the average.

The CHAIRMAN. Here we are giving you everything, the proposed amendment gives you free and unlimited, without touching your forelock, access to the discount window, no matter how small you are.

I would not quite say, oh, how sharper than a serpent's tongue is an ungrateful independent banker, but I hope when you think about it a little more, you draw a distinction between those who are trying to keep alive an independent banking system in this country and those who can think of nothing better than to up the deficit of this Nation now by more than half a billion dollars a year and give most of the benefit to the very large banks, against which I have nothing, but at least I think some attention to the independent banks could have been the subject of a sentence or two in your testimony.

Mr. CAMPBELL. Mr. Chairman, we do appreciate the efforts of members of this committee to provide benefits for the small banks by excluding the first $10 million in transaction accounts. We are primarily concerned with the explicit pricing. We feel that is such an unknown factor and such a complex problem that we would be remiss in representing, as officers of our association, that our rank-and-file people could accept these proposals. It is primarily a problem of timing.

The CHAIRMAN. The purpose of these hearings is not to get anyone to ingest every item of a complex proposal; it is to get views on different parts.

I take it then that your testimony, as amended, is that the independent bankers would favor the inherent progressivism of the reserve requirement provision contained in the so-called amendment to the Stanton bill?

Mr. CAMPBELL. Yes, we would so favor.

The CHAIRMAN. But on the business of charging for services, you say, in effect I believe, hold everything in abeyance until the Fed actually tells us what the charges are going to be and then proceed.

Mr. CAMPBELL. That is correct, Mr. Chairman. I happen to be a supplier of correspondent bank balances rather than a buyer of such balances. I realize that there is a lot of difference between the pricing methods of various banks. We rarely agree with their methods of pricing of services.

We rarely provide the balances that they think we should. But invariably, if we suggest withdrawing by closing our account, they invariably say no; we want you to stay with us.

The CHAIRMAN. The 400 correspondent banks of Mr. Hill's organization, whatever else may be said of them, have to compete against other correspondent banks?

Mr. CAMPBELL. Yes, that is correct.

The CHAIRMAN. And do they not all have nice guys going around their market area? I heard the words "three martini lunches" and that will be stricken from the record. But do they not go around being pleasant, ingratiating people who try to sell you a service because they know they have lots of competition and there are other people that can do the same paper-pushing job?

Mr. CAMPBELL. Certainly, Mr. Chairman, they do visit us; they are kind and they are also very helpful. We have been tremendously helped by the major banks in this country, in systems and services and, even though we complain about their charges at times, most generally they are fair. But we are still concerned about the pricing of services through the Fed.

The CHAIRMAN. I think you should be, and I will just close this panel by saying that it is not the purpose of the Banking Committee to do in either the independent bankers or the correspondent bankers. We view them as necessary parts of a very complex system.

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Thank you for your help this morning.

We will now hear from our second panel, Gov. Philip E. Coldwell of the Federal Reserve, Frank E. Morris, and Beryl W. Sprinkel of Chicago.

Governor Coldwell, I understand you have at least a modest time problem. Can you tell us what it is?

Governor COLDWELL. As you probably know, we are shy of Board members, and the Board is waiting for me because I am the quorum member this morning.

The CHAIRMAN. It is meeting this morning?

Governor COLDWELL. Yes.

The CHAIRMAN. Then if there is no objection, I am going to ask Governor Coldwell to proceed and the questioning of Governor Coldwell to proceed, and then we will examine the other two witnesses.

Governor Coldwell.

Governor COLDWELL. Thank you very much, Mr. Chairman.

The committee staff has requested that I summarize the presentation before you. I will do so under the assumption, of course, that the entire statement will be in the record.

The CHAIRMAN. Your statement is, under the rule and without objection, received in the record.

STATEMENT OF HON. PHILIP E. COLDWELL, MEMBER, BOARD OF GOVERNORS, FEDERAL RESERVE SYSTEM

Governor COLDWELL. I will make a very short statement then, Mr. Chairman.

I appreciate the opportunity to come here and elaborate further on some of the proposals of the Federal Reserve. I would like to specify two particular areas of concern: one on the basic membership question and the other on the pricing of the Federal Reserve services.

With regard to the membership issue, there is a lot of discussion about the degree to which the Federal Reserve can afford to have membership continue to erode. I do not think any of us has a specific point in mind at which Federal Reserve monetary policy becomes excessively difficult because of the erosion. But I do think there is a broader point to be made, which is that the Federal Reserve is making monetary policy for the Nation as a whole and in that effort it should be accorded as much strength and support as it can get in terms of the overall policy for the United States.

I do not think anyone really believes that monetary policy is developed just for banks or a limited number of member banks, but if they do, I hope we can disabuse them of the idea.

On the pricing question, there are some things which the committee has already discussed with the prior panel to which I would like to address myself.

First, I think it is a mistake to consider Federal Reserve payments mechanism services as being precisely those services which the correspondent banks provide. The correspondent banks that I know anything about have a whole kit full of services which they render, which the Federal Reserve does not render—items such as the encoding of checks and the demand deposit accounting of those checks.

Many of the correspondents with whom I have talked also use their payment systems roughly the same as the Federal Reserve does in the sense that there is a gross, overall total of correspondent balances to be maintained in the correspondent bank, and the individual costs of each of the services rendered are seldom specifically spelled out.

Mr. Hill said he knows precisely what his costs are. I am pleased to know that, because I have run into too many other banks who do not know that.

Another point with regard to Federal Reserve payments mechanisms is the purpose for which the Federal Reserve is in this field. It is quite true that we do have an operational presence in the payments mechanism, and we do some of the things which the correspondent banks do, but we also do a number of other things which I think the committee should bear in mind when we talk about pricing Federal Reserve services.

We operate a regulatory device, partly through an operational presence but partly through the basic regulation of the payments mechanism. We help enforce standards on MICR encoding and routing number systems, and we help insure that funds' availability are set with regard to the schedule of payments. If our operational presence were reduced entirely, somebody would have to do these public interest jobs. We think it is more desirable for a public body to be in this field and do the job of regulating by such an operational presence. We admit that we could be removed from that, but only at the cost and burden of an excessively tight regulatory examination, investigation, and enforcement program.

We are not interested in enlarging our correspondent bank network efforts. We think our operational presence is adequate now and see no reason to enlarge it. But neither do we see the desirability of handing over to a limited number of large correspondent banks the entire operational efforts in the payments mechanism without very careful regulation.

One of the things that the correspondents perhaps miss is that we maintain a certainty in the payments flows, occasioned by the Federal Reserve's presence in that system, and the check collection float which is the difference between the value of the credit for deposits given by the Reserve banks and the value of the checks collected.

If the private sector were to assume the responsibility of passing credit for collection in the same schedule, that expense of financing the float would, of course, be a substantial cost to the banking system.

I think it is vitally important that the Nation have available a fast, reliable, accurate payments network to support this Nation's monetary policy as well as the needs of banking and commerce.

Implementation of monetary policy is facilitated through the Federal Reserve's payments mechanism. We obtain some information through that mechanism which is important in the establishment and continuing handling of monetary policies. A substantial reduction in the role of the Federal Reserve could have an impact on Federal Reserve payments services provided the Treasury, also.

If we are going to reduce our personnel, equipment, and manpower, when the commercial bank checks and other payments mechanisms are priced out from under us, as Mr. Hill suggested, then somebody must take over the handling of the Treasury collection and transfers which we presently handle with the same equipment and personnel.

Similarly, the Federal Reserve uses a very complete courier service to deliver all of these checks and electronic funds transfer tapes. If we are to cut back on our operational presence, then clearly the courier service is going to have to be provided by somebody else.

I want to make it clear that I have no problem with using price, for example, to define the terms of access to services, bring about more efficient use of these services, or even to determine the role of the Federal Reserve in the payments mechanism as long as we do not provide such a concentration as to create problems for the Nation.

I do not believe it would be in our best interest to have the payments mechanism in the hands of a severely limited number of financial institutions. We have already been through this once in this century, and I would hope we would not repeat our error there.

It is not absolutely necessary for the Federal Reserve to price for many of its services in order to allow the private sector to compete. Their competition with us is clearly available already, as the witnesses have indicated on the prior panel. They do compete with us right now, in both correspondent banking services that we render and, in a much broader sense, other correspondent banking services.

My recommendation to the committee, Mr. Chairman, is that we take a very cautious approach toward the pricing of these services so that we do not unduly affect the performance of the payments mechanism. I believe it is important for us to see how pricing works and for the Federal Reserve to gain experience in pricing before we become bound to a formula which might do more harm than good.

I appreciate the committee's attention and will try to answer any questions, Mr. Chairman.

[Governor Coldwell's prepared statement follows:]

Statement by

Philip E. Coldwell

Member, Board of Governors of the Federal Reserve System

before the

Committee on Banking, Finance and Urban Affairs

House of Representatives

I am pleased to testify today on two important issues, membership in the Federal Reserve and pricing of Federal Reserve services. First, I would like to express my concern about the continuing erosion of membership in the Federal Reserve and the need to solve this problem. Next, I want to discuss the issue of pricing for Federal Reserve services. Most of my testimony will be devoted to discussing pricing because of its potential impact on membership and on the nation's payments mechanism. Congress should be fully aware that pricing for services without reducing the burden of membership will further contribute to banks leaving the Federal Reserve.

As a member of the Board and former President of the Federal Reserve Bank of Dallas, I have observed the withdrawal of banks from the Federal Reserve System for nearly 27 years. At first the banks withdrawing from the System were generally rather small. But in recent years larger--even large correspondent banks and frequent users of Federal Reserve services--have found the burden of membership too great to justify remaining in the System and others have indicated intentions to withdraw unless the burden of membership is relieved.

Over the years, the Board has expressed its concerns to Congress about the loss of member banks and has recommended ways to reverse membership loss. Chairman Miller again stressed this concern in his testimony last week. In his testimony he explained the reasons why banks are withdrawing from the Federal Reserve System. I want to stress the point that increased competition for transaction accounts--particularly interest bearing transaction accounts--has forced all financial institutions to become increasingly cost conscious. In turn, member banks facing this and other challenges to profitability have been forced to carefully weigh the costs of retaining their membership.

In addition, his testimony provides a review of the adverse implications that declining membership has for monetary management and the quality of the banking system. Chairman Miller stressed the importance of bringing equity among financial institutions. Let me emphasize two factors he mentioned. First, the ability of the Federal Reserve to guide innovation and foster constructive competition in the payments mechanism among financial institutions will be enhanced. Secondly, at such time as all financial institutions are bearing an equitable reserve burden, there will be no unfavorable economic effects to allowing uniform access to Federal Reserve services at equal costs and under equal conditions.

It is important for the United States to have a strong central bank and certainly in the current economic situation steps should be taken promptly to offset any contrary trend. I am sure that Congress is as concerned as we are about the inflationary pressures evident in our economy and therefore will be interested in assuring the strength of one of its primary agents for resisting inflation.

This line of thought leads me to hope that Congress will be willing to stop the erosion of membership. The most evident and clear-cut support Congress could enact would be legislation requiring universal reserves.

It is essential for everyone to understand that monetary policy is not developed for banks or even the limited number of member banks, so there appears to be no good reason for the nation's central bank to operate under the shackles of a voluntary membership structure. We can debate a specific monetary policy on its merits, but from any standpoint, I can see no public purpose to be served by limiting the effectiveness of the central bank. Monetary policy is made for the entire nation, not a limited sector of the banking community. All depository institutions are chartered in the public interest and all should be directly supportive of and participants in the implementation of policy.

I would like to express my views on the part of the Board's plan and the parts of the proposed legislation that deal with charging for Federal Reserve services. I will explore with you possible impacts charging will have on the nation's payments mechanism.

You are no doubt aware that the System has been considering for over two years the subject of charging for its services. As studies have progressed, we have become increasingly aware that there are problems in the application of the theory that pricing should result in a more efficient allocation of total resources to payments mechanism activities. I believe there is a much more important goal than attaining optimum allocation of resources. That goal should be the continuing ability of the Federal Reserve to assure the Congress and the nation of a smoothly functioning payments mechanism.

In considering pricing legislation, the Congress should be fully aware that the Federal Reserve has no intention of enlarging its role in the payments mechanism to the exclusion of the correspondent banks of the nation. Neither, however, does it intend to allow a few very large private sector firms to dominate services now provided by the Federal Reserve. This could result, ultimately, in problems similar to those in existence when Congress created the Federal Reserve System and gave it the power to establish clearing house services.

In its proposal to the Congress, the Board made the following statement:

> "In order to assure continued efficient functioning of the payments mechanism and to avoid major disruption during the transition to a more competitive environment, the Board would follow a conservative and flexible approach in establishing charges for Federal Reserve services. To this end, the System has concluded that its charges should be competitive with those for comparable services (when available) in the private sector. However, the Board would retain flexibility to alter charges or service policies in order to meet its responsibilities to maintain a satisfactory, basic level of service for the nation as a whole and to encourage innovations."

I would like to elaborate on this statement and explain why the Federal Reserve believes it has a responsibility to retain an ability to perform a "basic level of service" nationwide in payments activities.

Payments mechanism activities are an important aspect of the functioning of the nation's economy. The Federal Reserve through its currency and coin distribution, check collection, funds transfer, and U.S. Government security transfer services is actively involved in all vital components of money supply and money movement through the nation's payments system.

The payments mechanism of the United States functions quite well today. Enormous amounts of money flow among financial institutions each day. Much of the nation's business is carried out with check payments and as you know the Federal Reserve is a major participant in the check collection system. Orderly markets in federal funds and government securities are important to the government and the banking industry and to monetary policy. The Federal Reserve Communications System plays a vital role in supporting these markets.

The government in protecting the public interest has a substantial concern with the smooth functioning of financial markets and payments mechanism activities. I believe those interests can be protected in only two ways, either exclusively through regulation or through limited regulation and an operational presence such as the Federal Reserve currently has in the check collection system.

If the Federal Reserve operational presence in payments mechanism functions were materially reduced, then regulation of payments operations probably would be needed to protect safety and soundness of depository institutions or to avoid payments practices that are contrary to the public interest. Who, for example, would enforce standards such as MICR encoding and routing number systems? Who would ensure that funds availability is maintained at a reasonable level so that checks would remain as acceptable as they are today? If Federal Reserve operational presence were reduced, it would be necessary to establish a body of regulations and examination, investigation, and enforcement mechanisms to ensure an efficient and equitable payments mechanism. The costs and burden of such a program should be a significant factor in determining the pricing and operational posture of the Federal Reserve.

We believe that Congress looks to the Federal Reserve to protect the public interest in payments mechanism functions and we believe that the public interest can best be served by continued operational functions that are performed by the Federal Reserve Banks. Therefore, while pricing of Federal Reserve services is intended to bring about efficient allocation of resources, there is a need for sufficient pricing flexibility for the Federal Reserve to maintain its operational presence in payments operations. In particular, the Federal Reserve should continue to provide a basic level of service and protect the public interest in the safety and soundness of the nation's payments mechanism. As an example, consider that through the participation of both the Federal Reserve and the private sector the check collection system has evolved into a system with the following desirable features:

1) Certainty - Checks and other cash items drawn on any financial depository institution are collectible. There is almost universal payment for checks at face value by paying banks.

2) Speed - Checks represent money to the payee and the collecting bank. Current arrangements allow for availability of funds to collecting banks for any checks in 2-3 business days. Rules also exist to assure prompt notice of nonpayment of items.

3) Accuracy - The incidence of error is relatively small and not readily visible to the public. Procedures exist to assure maintenance of sufficient records to correct mistakes (lost items, missent items, etc.).

4) Efficiency - For items drawn on distant banks the Federal Reserve collection system helps assure a minimum number of institutional handlings. Balances maintained solely for settlement are also minimized because of the use of reserve accounts for settlement.

5) Optional collection channels available - It is possible for a bank to collect items through a number of options in the current system. Federal Reserve collection channels are used primarily by member correspondent banks. Smaller banks, both members and nonmembers, use a correspondent bank as their primary collecting agent.

6) Nationwide scope - A similar level of service is available to all collecting and paying banks wherever located.

In operating the collection service, a public institution can assure that all regions of the country are provided a basic level of service at a reasonable price. Federal Reserve operations in the check collection system assure that clearing time is relatively fast to all areas. And, they assure that terms of access to the check collection system are equitable. However, this is done by providing subsidies to low-volume and remote financial institutions. The private sector could provide such cross-subsidies only if it earns excessive profits in high volume, high profit regions.

The Federal Reserve Banks pass credit to depositors on a predetermined schedule that is intended to approximate collection times for the items deposited. The fact that these schedules are fixed provides a firm basis upon which depositing banks can plan their cash positions and manage their funds. This certainty also provides a way for commercial banks to pass credit to their depositors in an orderly fashion without accepting undue costs or risks.

This certainty is financed by the quantity known as Federal Reserve check collection float, which is the difference at any time between the value of credit for deposits given by the Reserve Banks and the value of checks collected. If the private sector were to assume the responsibility of passing credit for checks on the same schedule as the Reserve Banks, the expense of financing the float would be a substantial cost to the banking system that it does not now bear.

If the Federal Reserve is not given the flexibility to adjust its prices to the marketplace, there is a possibility that the private sector will skim off only the most profitable services leaving the Federal Reserve with the least profitable services and significantly higher average costs. For example, in the check area the Federal Reserve could be left collecting checks drawn on low-volume and remote banks. Since the cost of providing only this service would be extremely high, it would then have to be decided whether users of Federal Reserve services should be subsidized in order to assure continued acceptability of these checks.

It is vitally important that the nation have available a fast, reliable and accurate payments network to support the nation's monetary policy as well as the needs of banking and commerce. Implementation of monetary policy is facilitated through Federal Reserve payments mechanism operations. For example, the wire transfer of funds and securities capabilities of the System provide a fast, reliable and accurate vehicle for the effects of open market operations to flow across the banking industry. Our extensive involvement in check collection operations allows us early warning of bank liquidity problems which become evident when settlement for checks presented each day appears to be increasingly difficult for a bank. Also, if normal payments mechanism services are interrupted by severe weather or other emergencies, these circumstances are reported to the open market staff who can forecast monetary policy implementation strategy utilizing data derived from internal operating reports.

A substantial reduction in the role of the Federal Reserve in the check collection system could have an impact on Federal Reserve payments services provided to the Treasury Department. Currently, the Federal Reserve provides many services that facilitate the payment of Government obligations. Financial institutions deposit Treasury checks with the Federal Reserve for payment. The largest number of these checks are Social Security and other benefit payments. For the most part, these checks are issued and cleared during the first few days of each month. The Federal Reserve uses employees and equipment which are employed in processing commercial checks to assist in processing Government checks. If commercial check volume were reduced to a point where employment and equipment is cut back, these resources would no longer be available to assist in processing Government checks.

The Federal Reserve uses the same courier service to deliver Treasury electronic funds transfer payments that it uses to deliver checks to financial institutions. If the number of banks to which we deliver commercial checks were reduced, the courier service would also be reduced. Without the courier service, the Treasury would have to rely on other means for delivering Federal Government payments.

Given the Federal Reserve's role as a provider of a basic level of service nationwide, which I believe is a major factor contributing to the smooth functioning of the payments mechanism, let me caution against any constraining legislation which could disrupt money flow operations. A provision in the Stanton bill, H.R. 12706, would require the Federal

Reserve to adhere to a fixed formula in setting prices. The provision which requires the Federal Reserve to base its prices on direct and indirect costs as well as costs that would have been incurred by a private firm might place the Federal Reserve Banks at a competitive disadvantage in relation to private firms. Private firms rarely have their prices bound to a fixed formula. It is my impression that complete cost accounting in the banking system is a little used procedure when pricing individual services. In most cases, adjustments are simply made to prevailing market prices, with the only price constraint being coverage of all costs in the long run. It is a common practice for correspondent banks which provide services somewhat comparable to those offered by the Federal Reserve to cross-subsidize their service lines. Banks may suffer losses on payments services, for example, while recovering those losses from earnings from other bank services such as lines of credit and loan participations. My concern is that unless the Federal Reserve utilizes similar flexibility, it will not be able to adjust to the realities of the competitive marketplace and may be forced to reduce or abandon its role as the provider of a basic level of service nationwide.

Let me make it clear that I have no problem with using pricing to define the terms of access to Federal Reserve services, to bring about a more efficient use of those services, or even to determine the role the Federal Reserve should play in the payments mechanism as long as we do not allow private concentrations to be substituted for the Federal Reserve. I do not believe that it would be in the best interest of our country to have the payments mechanism in the hands of a severely limited number of private institutions and I suspect that this concern is shared by a great many smaller banks and other nonbank financial institutions.

It is not absolutely necessary for the Federal Reserve to price for many of its services in order to allow the private sector to compete. The private sector is able to compete with the Federal Reserve because we have exercised restraint in our involvement in the payments mechanism. For example, correspondent banks and service organizations offer significantly broader check processing services including dollar amount encoding, proof of deposits, transit check processing (including both collection of some checks and routing others on for collection through other banks and the Federal Reserve) and demand deposit accounting (posting of checks to customer accounts). In providing transit check processing, the organizations are frequently able to improve upon Federal Reserve funds availability by direct routing of checks to banks. It should be made clear that Federal Reserve check clearing operations and commercial bank operations currently differ in many respects. A considerable proportion of Federal Reserve expense is related to delivery of checks to all banks in the nation each day and to transportation of checks among zones nationwide. Commercial banks expedite collection of checks based on the dollar amount of the items while the Federal Reserve generally does not discriminate based on dollar value. The Federal Reserve sets rather stringent pre-sorting requirements on depositing banks and requires all items to be fully encoded prior to deposit while commercial banks are much more liberal in sorting requirements and will perform encoding operations for a price.

My recommendation is that we take a cautious approach towards pricing of Federal Reserve services so that we do not unduly affect the performance of the payments mechanism. I believe that it is important for us to at least see how pricing works and for the Federal Reserve to gain experience in pricing before we become bound to a formula which may do more harm than good. I think this argues for flexibility in establishing prices so that pricing can help bring about a more efficient use of payments services while at the same time acknowledging the role of the Federal Reserve to continue to set the rules of the road and to provide a basic level of service nationwide.

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The CHAIRMAN. Thank you very much, Governor Coldwell.

I appreciate what you say on page 3, that the Federal Reserve System has been considering for over 2 years the subject of charging for its services. Now I do not want to brag too much about the Banking, Finance and Urban Affairs Committee, but we, on July 11, scarcely 2 weeks ago, were for the first time given by the Fed its statement of what it wanted, and two bills.

Governor COLDWELL. Right.

The CHAIRMAN. Those bills were introduced by me, Mr. Coldwell, 4 days later; immediately hearings have been scheduled, of which this is one, and we hope to complete our hearing process within the next few days, because when the Fed tells us something is imperative, we believe the Fed.

But we have just heard a respected witness from the Independent Bankers Association and a respected witness from the Association of Reserve City Bankers say that they cannot really get a grip on this thing until they know what you are going to charge for your services. You have been at it for 2 years, you have 800 economists and God knows how many computers.

Can you get up here by next Monday what you are going to charge for your services? It would help Mr. Stanton, who I think made a valiant attempt in his bill to set forth what he thought was a reasonable, just and fair basis for charging. So why do you not let us in on these arcane secrets and then perhaps we can be accommodative?

How about Monday? If not Monday, how about Tuesday?

Governor COLDWELL. Mr. Chairman, we do appreciate the committee's prompt attention to this.

The question of pricing is a very serious one to us, on which we frankly did not have a lot of help. Our past background, as now, is a nonpricing environment. So we have been looking at the pricing question with a great deal of care, and there are a number of unresolved questions: for example, should pricing be on the basis of individual office, individual check, or a correspondent balance type approach? Should pricing be in terms of the individual functions which we perform, such as the balancing of accounts or settlement; and should correspondent services be priced separately?

Should we price for encoding checks? Should we make prices based on our present services that we provide, or should we change those services?

Right now we are not competitive with the correspondent banking system in terms of the services that we are rendering. We demand encoded checks from our banks, whereas correspondent banks permit nonencoded checks. They do the encoding for the respondent bank.

These are all problems we have been wrestling with for 2 years and I will quickly admit to you that we have not put this on the "front burner" largely because of the question of the membership issue, and you will recall that pricing was not a membership issue to us. We were considering primarily how to relieve the burden of membership and pricing adds to the burden of membership; it does not relieve it.

The CHAIRMAN. We are somewhat in the position that confronted the legislature of Kansas some years ago. I am told, when faced with an increasing number of railroad at-grade collisions, they passed that famous law which said, when two railroad trains shall approach each other at grade, each shall stop and shall not proceed until the other has passed.

You are not going to do anything with interest rates until you get this price thing settled? We are not going to do anything on the interest rate thing until we know how badly we are going to fleece the taxpayers, who very seldom get mentioned at these hearings.

When can we get together? We have worked hard. Our staff has been working every weekend on this, most nights; many members on both sides of the aisle have worked very hard. I would like a date from you when you are going to be able to bring forth, to hand this committee—and, if you wish, to concurrently publish it in the Federal Register, that is entirely your privilege—your proposed pricing schedule.

Governor COLDWELL. Mr. Chairman, as of last week I saw my first listing of a preliminary schedule of costs. We will be holding a meeting on that within a week or two, at most, to refine those figures.

I hope that within a period of 3 weeks we can send you and others a look at the "first cut" of pricing.

Now I recognize that this is going to be approximate at best, because we do not know where we stand on the pricing mechanism. We cannot tell you precisely whether the charge that we make for processing a check is going to be a charge that is reasonable in the light of your considerations. We do know what our costs are, both direct and indirect. Our accounting system gives us even the allocation of the last element of overhead cost of a bank.

The CHAIRMAN. If you have that, you have rounded third base and are heading home.

Governor COLDWELL. Well, we are headed home with the exception that the correspondent banking, or I should say the reserve city banking, groups would like to have us add a capital cost on top of that.

The CHAIRMAN. Have you heard them on that? You have heard from them on this?

Governor COLDWELL. Oh, yes, we have heard from them.

The CHAIRMAN. Well, you are the, you know, you are where the buck stops, 14-years, independence, tennis courts, everything. You really ought to decide whether the correspondent banks are right—I do not know what their position is—or wrong. Put it on paper. We will give them an opportunity to be heard, and I am sure you will too.

Governor COLDWELL. I am perfectly willing to do that, Mr. Chairman.

The CHAIRMAN. I have to remind you of our congressional schedule. It was my hope that we could complete action and report out to the floor and get a rule before we go into a rather brief recess on August 18. We return for duty on September 7 and adjourn for the year on October 7.

I want to see legislation on this broad, broad subject passed this year because I take the Fed seriously when the Chairman of the Board and the Governors come up and say this is a situation that demands immediate attention. But if you are not even going to give us your proposed pricing schedule until after we go into recess on August 18, I think you doom the Fed's request for prompt action.

So I must tell you that our staff stands ready to assist yours in preparing those regulations; we have become knowledgeable about many of these subjects; members of this committee will be glad to sit at night with your people after we get through with our schedule. But let us not delay this matter which the Fed itself has placed before us by saying that that which has been before you for 2 years is now going to take another 3 weeks or so to present to us.

Mr. Moorhead.

Mr. MOORHEAD. Thank you, Mr. Chairman.

Governor, one of the next witnesses will be Mr. Sprinkel who says in his written testimony:

It can be demonstrated that the Federal Reserve could regulate the money supply with zero reserve requirements so long as it is able to determine the monetary base.

Do you agree with that statement, sir?

Governor COLDWELL. No, I do not.

Mr. MOORHEAD. Could you give us the reasons why? I think it is fairly important.

Governor COLDWELL. Well, I think this gets back to a lot of relationships between reserves and the functions of money and the demand therefore.

I will not defend Mr. Sprinkel's position. There are equally competent economists who will tell you that some base for which monetary policy can act is necessary for an effective and efficient monetary policy.

What Mr. Sprinkle is saying, in effect, is that we do not need a base to operate on, that we can increase the amount of reserves or decrease them without a base to work on.

Mr. MOORHEAD. It seems to me that issue is important because I think probably then the greatest discouragement of membership is the idle reserve requirement which you can correct either by eliminating the reserve requirement or by paying interest on it; would that be correct, sir?

Governor COLDWELL. Or making it a universal requirement for everyone, any one of the three.

Mr. MOORHEAD. Now, on the pricing mechanism, to follow up on the Chairman's request, it seems to me that the Fed is in an extremely difficult position which became quite apparent with the previous witnesses; it is in the interest of many of the members of the Independent Bankers Association, and the Fed, to keep those charges as low as possible to attract IBA and other banks into the system, but of course the correspondent banks want to keep it as high as possible so that they will not be driven out of business.

You are between a rock and a hard place, are you not, sir?

Governor COLDWELL. Well, I think the correspondent bankers have one question they need to answer. If they are able to compete with us now when we do not charge at all, why should the problem of charging something create a big difficulty for them?

We do not presently charge our member banks, except by the sterile reserves, which all members must pay for.

In terms of the new charging arrangement, I am sure that we will charge at least our direct and probably our indirect costs as we have them isolated. What we need to do is to be careful that we do not put ourselves in a position where the remote or very small commercial bank is in effect charged a very high price, whereas the correspondent banker just takes the cream of the crop such as the New York to Chicago type heavy volume areas, leaving only the remote and small volume to other people.

One of the basic reasons why the Fed has been in this business is to provide a basic level of service to all banks and to assure ourselves a certainty and speed of credit flows in this country.

Mr. MOORHEAD. I unfortunately have to leave and cannot question Mr. Sprinkel. He supports the amendment which would tie the discount rate to the average yield on Treasury bills.

Do you agree or disagree with that proposal?

Governor COLDWELL. I disagree with it, Congressman. We have already had some examples of this. Canada did it for some time, but they decided it did not work. All of us have problems with discount rate determination, as witness the last month when we had the problem of raising it again. There are some announcement problems attached to it; but we think we would be giving up something by the loss of that announcement ability if we really want to alert the entire community of a change in monetary policy.

Mr. MOORHEAD. Mr. Hill testified, I think in his oral testimony—I think I have it correct, at least substantially—he said,

> I believe that the erosion of membership will hamper the ability of the Fed to control monetary policy and hence inflation.

Is that the thrust of your testimony today, sir?

Governor COLDWELL. Yes, it would be.

Mr. MOORHEAD. Thank you.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Mr. Moorhead.

Mr. Stanton.

Mr. STANTON. Mr. Chairman, I have several questions, but I understand Governor Coldwell's time problems, and also the other panel is waiting. I am like Mr. Moorhead. I have a luncheon commitment. I can only be here a little longer.

I would simply make one statement. That would be to ask that several questions I do have for you, Governor Coldwell, I might insert into the record, and if you could answer them, I would appreciate that.

Second, back to the question of the specific pricing of membership, Mr. Chairman, I am not sure if that is exactly that big of a problem as has been emphasized here this morning.

I don't know the exact figures, but it seems to me the Fed, when they sent us their proposal, had some specific figures—at least I took them as specific—of a phase-in of the services to be rendered over two phases.

Phase 1 would bring in, I think, some $225 million, and phase 2 would bring in $400 million. I think roughly that was the figure. So, if we could just do the reverse and have some of the statistics of which that $400 million was based on, it would provide, I think, the general atmosphere of what we are talking about, rather than the specific.

The CHAIRMAN. I agree. Somebody must have picked up $461 million, or whatever it was. Let us see what it was.

Mr. STANTON. Thank you, Mr. Chairman.

The CHAIRMAN. Mr. Pattison?

Mr. PATTISON. In the interest of time, Mr. Chairman, I think I would withhold at this time.

The CHAIRMAN. All right.

Mr. Grassley?

Mr. GRASSLEY. Mr. Coldwell, on page 10 of your testimony, where you say,

> My concern is that unless the Federal Reserve utilizes similar flexibility it will not be able to adjust to the realities of the competitive marketplace, and may be forced to reduce or abandon its role as a provider of basic level of services nationwide.

Is that really a realistic fear? It seemed to me that maybe you are throwing out here something that isn't real just to get our attention.

Governor COLDWELL. We don't really know, Congressman. That is our problem. We have some correspondent data which include specific charges.

We know our own costs. If you take it just on the face value of those two figures, I think we are probably 25 to 30 percent lower than some of the correspondent data we know of.

On the other hand, we know perfectly well that where an individual entrepreneur wants to make a loss leader, all he has to do is cut his prices to get into a particular area.

We don't really know what the situation will be after we price. We don't know whether we are going to have continued handling of the checks the way they are now, or a much larger or much smaller volume.

It is our intent to try to keep it about where it is until we see the effects of pricing.

Mr. GRASSLEY. That is the only question I have, Mr. Chairman.

The CHAIRMAN. Thank you.

Mrs. Fenwick?

Mrs. FENWICK. I just have a short question, or two short questions. One, how many member banks has the Federal Reserve lost?

Governor COLDWELL. I am sorry, I couldn't hear you.

Mrs. FENWICK. I understand that the Federal Reserve has lost member banks. How many member banks?

Governor COLDWELL. Congresswoman, I am not sure I can precisely cite the number.

Mrs. FENWICK. I see.

Governor COLDWELL. It has been a steady erosion. I have watched it for 27 years.

Mrs. FENWICK. From the high to the present, if you could give us those figures, I would be grateful.

Governor COLDWELL. 430 over the past 8 years, roughly.

Mrs. FENWICK. They have lost 430 members? That is considerable. I believe you plan to transfer some $575 million from surplus to the Treasury in order to pay for the interest that will be the carrot to draw members back.

How did you come to that figure? As I understand it, on page 5 of the chart that has been prepared for us, the loss to the U.S. Treasury will be some $300 million a year. Am I correct in that?

Governor COLDWELL. I believe that is correct.

Mrs. FENWICK. How did you happen to pick $575 million?

Governor COLDWELL. It is a cumulative figure.

Mrs. FENWICK. For 2 years?

Governor COLDWELL. Yes. It is cumulative. In other words, you would lose that amount over 3 years, but it would be offset through the transfer from the Federal Reserve surplus. A further offset would occur because of higher personal or commercial bank taxes paid on the interest earnings from reserves.

Mrs. FENWICK. Well, the price tag for services, that is already figured in. Interest payment to the banks would cost $765 million. The revenue loss to the Federal Reserve caused by the reduced reserve requirements would cost some $350 million.

But your pricing for services would reduce that again to a $605 million loss, if I read your figures correctly. But the point I am trying to get at is, you are going to take this from your surplus. Why do you keep a surplus of that size?

Fifty-six point seven billion dollars has been paid to the U.S. Treasury since you started, but you still have a very considerable surplus on hand, over $1 billion.

Governor COLDWELL. I was asked the same question by Senator Proxmire at two separate hearings 1 year apart. My response to him, as I am afraid it is going to have to be to you, is that we are required by law to have a surplus; and we are a banking institution, and most banks have surplus accounts.

Now, that is a very weak excuse.

Mrs. FENWICK. Well, how do you feel about this universal requirement?

Governor COLDWELL. I think it is the best way to go, partly because I think it does broaden the total group of banks and depository institutions for which monetary policy would be directed in the first initial stage.

At present, as you know, we have only about 40 or 45 percent of the banks and are having to increase the pressure of our monetary policy in order to get the secondary effects.

Mrs. FENWICK. I see. Thank you.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Mrs. Fenwick.

Governor Coldwell, we appreciate your staying with us.

Governor COLDWELL. Thank you very much, Mr. Chairman.

The CHAIRMAN. We will now hear from an old friend of this committee, the executive vice president and economist of the Harris Trust & Savings Bank of Chicago, Beryl W. Sprinkel.

Mr. Sprinkel has some good ideas to share with us.

STATEMENT OF BERYL W. SPRINKEL, EXECUTIVE VICE PRESIDENT AND ECONOMIST, HARRIS TRUST & SAVINGS BANK, CHICAGO, ILL.

Mr. SPRINKEL. Thank you.

Mr. Chairman and other distinguished members of the House Committee on Banking, Finance and Urban Affairs: I appreciate the opportunity to express my opinions concerning the important banking and monetary policy issues now under consideration. Rather than commenting upon the details of each proposal, I will attempt to address what I believe to be the basic issues underlying all proposals. The views are my own and not necesarily those of my employer, the Harris Trust & Savings Bank of Chicago.

Reserve requirements as presently imposed can best be viewed as a tax on banking, whose cost is ultimately paid by the user of banking services. Required reserves do not represent an important source of liquidity as once believed. Nor is it necessary for all banks and other financial intermediaries to maintain reserves for the purpose of improving the execution of monetary policy. In fact, it can be demonstrated that the Federal Reserve can regulate the money supply with zero reserve requirements so long as it is able to determine the monetary base. Therefore, I cannot support universal reserve requirements since the costs would very probably outweigh any resulting benefits.

I support proposed reforms to pay interest on required reserves while charging banks for services provided by the Federal Reserve. Central bank services are not a free good, and explicit pricing of these services will lead to a better allocation of resources. Reduction in required reserves and payment of interest on those reserves will serve to reduce the tax on banking services. Although the bills under consideration do not remove the prohibition of interest payment on demand deposits, I believe such a change would be desirable. Permission for explicit payment of such interest by commercial banks would be preferable to the various techniques currently used to reward demand deposit holders. The above reforms would improve "the efficiency and competitiveness of our financial system."

In my opinion, the "conduct of monetary policy" would be improved by adopting uniform reserve requirements for banks rather than the present system of variable reserve requirements. Shifts of deposit funds between institutions with different marginal reserve requirements or between different deposit categories in the same bank changes the money multiplier in an unpredictable way. Shifts in the ratio between the monetary base and deposits makes it difficult, if not impossible, to predict the monetary effect of a given Federal Reserve action. Adoption of a "progressive scale of reserve requirements" as proposed in the amendment to H.R. 12706 would exacerbate the monetary control problem while levying a higher tax on success.

From a monetary control point of view, all deposits should be subject to identical reserve requirements. In April this year all deposits subject to reserve requirements amounted to $586.1 billion. Reserves on deposit at the Federal Reserve banks amounted to $27.8 billion. If the vault cash reserves requirement were eliminated and required reserves were reduced $5 billion as proposed, there would remain $22.8 billion required reserves for $586.1 billion deposits; an average requirement of 3.9 percent. If all commercial bank deposits were made subject to reserve requirements, the average required reserve ratio would decline to 2.5 percent. Any move toward a more uniform system of reserve requirements would be an improvement over the present multiple reserve requirement as reflected in the following table:

MEMBER BANK RESERVE REQUIREMENTS[1]

[Percent of deposits]

Type of deposit, and deposit interval in millions of dollars	Requirements in effect May 31, 1978		Previous requirements	
	Percent	Effective date	Percent	Effective date
Net demand:[2]				
0 to 2	7	Dec .30, 1976	7½	Feb. 13, 1975
2 to 10	9½	do	10	Do.
10 to 100	11¾	do	12	Do.
100 to 400	12¾	do	13	Do.
Over 400	16¼	do	16½	Do.
Time:[2 3]				
Savings	3	Mar. 16, 1967	3½	Mar. 2, 1967
Other time:				
0 to 5, maturing in—				
30 to 179 days	3	do	3½	Do.
180 days to 4 years	[4] 2½	Jan. 8, 1976	3	Mar. 16, 1967
4 years or more	[4] 1	Oct. 30, 1975	3	Do.
Over 5, maturing in—				
30 to 179 days	6	Dec. 30, 1974	5	Oct. 19, 1974
180 days to 4 years	[4] 2½	Jan. 8, 1976	3	Dec. 12, 1970
4 years or more	[4] 1	Oct. 30, 1975	3	Do.

	Legal limits, May 31, 1978, minimum	Legal limits, May 31, 1978, maximum
Net demand:		
Reserve city banks	10	22
Other banks	7	14
Time	3	10

[1] For changes in reserve requirements beginning 1963, see Board's Annual Statistical Digest, 1971–1975 and for prior changes, see Board's Annual Report for 1976, table 13.

[2] (a) Requirement schedules are graduated, and each deposit interval applies to that part of the deposits of each bank. Demand deposits subject to reserve requirements are gross demand deposits minus cash items in process of collection and demand balances due from domestic banks.

(b) The Federal Reserve Act specifies different ranges of requirements for reserve city banks and for other banks. Reserve cities are designated under a criterion adopted effective Nov. 9, 1972, by which a bank having net demand deposits of more than $400,000,000 is considered to have the character of business of a reserve city bank. The presence of the head office of such a bank constitutes designation of that place as reserve city. Cities in which there are F.R. Banks or branches are also reserve cities. Any banks having net demand deposits of $400, 000, 000 or less are considered to have the character of business of banks outside of reserve cities and are permitted to maintain reserves at ratios set for banks not in reserve cities. For details see the Board's Regulation D.

(c) The Board's Regulation M requires a 4-percent reserve against net balances due from domestic banks to their foreign branches and to foreign banks abroad. Effective Dec. 1, 1977, a 1-percent reserve is required against deposits that foreign branches of U.S. banks use for lending to U.S. residents. Loans aggregating $100,000 or less to any U.S. resident are excluded from computations, as are total loans of a bank to U.S. residents if not exceeding $1,000,000. Regulation D imposes a similar reserve requirement on borrowings from foreign banks by domestic offices of a member bank.

[3] Negotiable orders of withdrawal (NOW) accounts and time deposits such as Christmas and vacation club accounts are subject to the same requirements as savings deposits.

[4] The average of reserves on savings and other time deposits must be at least 3-percent ,the minimum specified by law

Note: Required reserves must be held in the form of deposits with F.R. banks or vault cash.

I just want to read down the variations in marginal reserve requirements. They defy understanding, much less memory: 7 percent, 9½ percent, 11¾ percent, 12¾ percent, 16¼ percent, 3 percent, again 3 percent, 2½ percent, 1 percent, 6 percent, 2½ percent, and 1 percent.

Even the proposal to exempt the first $10 million in deposits from reserve requirements would be an improvement over the present system. However, moves to subsidize smaller banks through lower reserve requirements still creates problems with respect to the conduct of monetary policy. If Congress desires to subsidize smaller banks, this could be accomplished more efficiently by other means.

In addition to supporting more unform reserve requirements, I support three other proposed changes recently made by Chairman Reuss of the Committee on Banking, which I believe will further improve the operation of monetary policy.

First, set the agreed-upon reserve requirements by law and remove the present ability of the Federal Reserve Board to vary them within prescribed limits. The power to raise and lower reserve requirements is the power to impose higher and lower taxes upon the banking industry. This power should reside with our elected representatives, that is, the Congress and the President. Furthermore, variation in reserve requirements is a blunt instrument of monetary policy and results can be better achieved through incremental adjustments in open market operations.

Second, tie the discount rate to the average yield on Treasury bills with less than 92-day maturities issued during the previous 2 weeks. Under present circumstances, the discount rate is adjusted infrequently and there is a tendency for commercial bank borrowing from the Federal Reserve to soar as Federal funds and the Treasury bill rate rises relative to the discount rate. Borrowing banks get a subsidized bargain, but Federal Reserve credit soars, and unless offset by open market sales, so does the money supply. Automatic adjustment of the discount rate would lessen this disturbance and frequent adjustment would remove the sometimes disturbing announcement effect of discount rate changes.

Finally, I support more frequent acquisition of nonmember deposit data which should enable the Federal Reserve to better measure the various money supplies. It is difficult to determine appropriate monetary actions when the Federal Open Market Committee does not know the size of the recent and present money supply. Since the acquisition of this data is important for public policy and does involve a private cost, perhaps the Federal Reserve should consider reimbursing financial institutions for this cost.

Two additional institutional changes bearing on monetary policy execution that are not proposed but that should be considered are: First, elimination of lagged reserve computations. Presently this week's required reserves are based on deposits outstanding 2 weeks ago. The necessary attempt of banks to acquire reserves to meet obligations determined 2 weeks before is an unnecessary interference with Federal Reserve attempts to regulate monetary growth. Basing this week's required reserves on this week's deposits would reduce market interference; and second, staggering of reserve settlement days for member banks or expanding the "allowable carry-forward" would reduce the frequent extreme fluctuations in Federal funds each Wednesday.

Reducing variation in marginal reserve requirements, floating the discount rate, legislating reserve requirements, acquiring more timely deposit data, eliminating lagged reserve settlements, and staggering reserve settlement days would improve monetary policy formulation and execution. I once believed the Congressional Monetary Resolution, later enacted into law and adopted by the Federal Open Market Committee, would similarly facilitate achievement of a stabilizing monetary policy. Indeed, the objective of gradually reducing monetary growth until it was eventually commensurate with real output was and is the right objective. But alas, as monetary targets gradually receded in recent years, monetary growth accelerated. The music was soothing, but the results have been rising inflation, as money growth accelerated. I reluctantly conclude that regardless of improved structural adjustments such as those just discussed, there is little hope for monetary policy becoming a stabilizing influence upon our economy until the Federal Reserve changes its operating technique and permits the market to determine the Fed funds rate while it concentrates its attention on regulating growth in the monetary base or another closely related aggregate. Until this necessary reform is adopted by the Federal Open Market Committee, monetary policy will remain a procyclical rather than a stabilizing influence upon our economy.

Thank you.

The CHAIRMAN. Thank you, Mr. Sprinkel.

Now Frank E. Morris, president of the Federal Reserve Bank of Boston.

Let me take this opportunity, Mr. Morris, to congratulate you on the economic development work in your Federal Reserve district which your bank has been conducting for some years through seminars, publications and general leadership. It is a model for the whole country.

I have taken the liberty of plagiarizing some of the things you have been doing, seeing that they are done in our own Federal Reserve district.

STATEMENT OF FRANK E. MORRIS, PRESIDENT, FEDERAL RESERVE BANK OF BOSTON

Mr. MORRIS. Thank you, sir. I am very pleased to be here.

As you know, the New England area has been the area most impacted by the membership problem in recent years.

I will abbreviate my statement, Mr. Chairman.

The CHAIRMAN. Your entire statement will of course be included in full in the record.

Mr. MORRIS. Thank you, sir.

When Congress was drafting the Federal Reserve Act 65 years ago, I don't believe it contemplated that in 1978 the cost of membership in the Federal Reserve System would lead to a large erosion of membership in the System and impair the very objectives for which the Federal Reserve Act was written.

The erosion of membership impairs our lenders-of-last-resort function because it means fewer and fewer banks have direct and quick access to the discount window.

For example, in New England now we have 56 banks with deposits in excess of $100 million. Of these 56 banks, 29 are now not members of the Federal Reserve, and they have deposits of $8 billion.

These 29 large banks are going to have to depend upon the correspondent banking system in a liquidity crisis because we will not be able to deal rapidly with their needs the way we can with member banks.

Second, I am concerned about the shrinking reserve base. Mr. Sprinkel argued that we don't need a reserve base in order to control the money supply. He said as long as we have the monetary base, we can control the supply.

But that confused me a bit because member bank reserves are an important component of that monetary base.

The question is not whether we can control the money supply at all. The question is can we control it with the precision that the Congress is asking us to control it.

Member banks reserves are the fulcrum upon which our monetary management actions take place. We have to try to estimate day by day how many deposits will be generated with a given input of reserves. As that fulcrum gets smaller and smaller relative to the total deposit base, our estimates are going to get more and more inaccurate.

One of the early monetarists, Henry Simons of the University of Chicago, was sufficiently concerned about this precision aspect of monetary control that he argued for a 100-percent Reserve System, so that the central bank would know if it put in a dollar of reserves it got a dollar of deposits; no more, no less.

Well, I don't think anyone ever seriously considered a 100-percent Reserve System, but I think it is clear that if the body of reserves shrinks relative to the body of deposits, that estimating the effect of our actions on the money supply is going to grow more and more difficult.

Now, turning to page 2 of my statement, I have some information on the decline of membership in New England in the recent past, and the prospective decline of membership if nothing is done about this problem.

In 1977, 11 banks in New England and 58 banks in the rest of the United States withdrew from the Federal Reserve System. These 11 banks accounted for about 5 percent of the total of member banks in New England, and had desposits amounting to more than 10 percent of total deposits held at all member banks.

By the end of 1977, the proportion of insured commercial bank deposits held by member banks in New England had fallen below 63 percent as compared to 75 percent in the rest of the country.

In the past, the membership problem has largely been restricted to small banks. But this is no longer the case. During 1977, 8 of the 11 banks which left the System in New England and 7 of the 58 banks which withdrew in the rest of the country had deposits of $100 million or more, and these 15 banks had total deposits of $3.3 billion.

Now, I have been talking in a very open manner to our member banks in New England, urging them to postpone temporarily any decision to leave the System since the Federal Reserve was going to seek congressional action to deal with the membership problem.

They have by and large heeded my advice. Thus far in 1978, only three banks have announced target dates for withdrawal. However, an additional 34 banks have indicated to me that they are seriously considering withdrawal from membership.

Of these 34 banks, 14 banks have deposits of $100 million to $500 million, and 3 have deposits over $500 million. Together, these 37 banks that may leave the System if nothing is done have deposits of $5.3 billion and account for almost 28 percent of deposits currently held by all member banks in New England.

These banks currently keep $273 million in reserves with the Federal Reserve Bank of Boston, upon which we earned and turned over to the Treasury last year about $18 million.

If no action is taken to deal with the membership problem, I think it is probable that by the end of 1979, Federal Reserve member banks will hold less than half of all commercial bank deposits in New England.

Mr. Hill, I think, pointed out some of the reasons why the rate of withdrawal of member banks in New England has been greater than the rest of the country.

We have a very aggressive, competitive environment in New England, probably the most competitive retail banking environment in the country. We have thrift institutions which unlike their counterparts in most other sections of the country can offer full service banking to the consumer.

This intensified retail banking competition has resulted in lower profit margins for New England bankers. In 1977, in Massachusetts banks, net income before taxes and securities transactions as a percentage of total assets was 0.76 percent. The corresponding figure for commercial banks nationally in 1977 was 1.09 percent, 43 percent greater than the Massachusetts average.

So, this relatively weaker earnings performance has generated pressure to increase earnings by leaving the Federal Reserve and avoiding what I call the Federal banking franchise tax.

All of the New England banks that have left the System have done so very reluctantly. They are particularly reluctant to give up direct access to the discount window. But the pressure of the bottom line has just been too great to permit them to remain members of the System.

I would like to elaborate a bit on why I am concerned about the loss of the lender-of-last-resort function as more and more banks leave the System.

I think it is rendering our banking system more vulnerable, and the ability of the economy to withstand financial shocks is being lessened by the fact that an increasing proportion of banks will not have access to the discount window.

In recent years the development of sophisticated techniques of liability management has lessened the importance of the discount window as a routine source of liquidity. Many banks leaving the System believe that if need should arise, they will be able to obtain funds from their large correspondents.

In the normal course of events, there is no doubt that the large banks will be able to meet the liquidity needs of their smaller correspondents. But if a general liquidity crisis should occur, the large banks may not be able or willing to meet the needs of all nonmember banks.

Even if they have the funds available, or are able to obtain them from the Federal Reserve, the large banks may be reluctant to assume the substantial credit risks involved in numerous large-scale advances to their correspondents.

The committee should remember that the original impetus to the formation of the Federal Reserve was the failure of the correspondent network to provide adequate liquidity to country banks during the financial crisis of the early 1900's.

The Federal Reserve is the only lender that can unconditionally guarantee a sufficient supply of the funds in times of crisis. Performance of this guarantee requires a direct relationship between the Federal Reserve and the borrowing bank.

The decline in membership thus endangers the performance of the Federal Reserve function which is only of routine importance presently, but whose successful implementation in time of crisis is imperative.

There are obviously two ways of dealing with this problem. One is to mandate uniform reserve requirements, placing all financial institutions on an equal footing, a solution which would increase the revenues of the Treasury.

But if Congress remains unwilling to do this, it should approve the only alternative solution—to eliminate the excessive burden of membership in the Federal Reserve.

Now, in my judgment the Board's cost estimates of its proposal are much too high since they make no allowance for the effect of increased membership.

There is no doubt in my mind that if the Board's program were adopted, most of the New England banks which left the System would rejoin promptly, along with many commercial banks and some savings banks which have never been members.

In the long run, I believe that the cost of the Board's program to the Treasury will be less than the cost of doing nothing and suffering the declining revenues produced by a continued decline in membership.

Now I would like to turn to the issue of pricing Federal Reserve services, for which I have been a long-term advocate. It is an economic truism that any costly service provided free of charge will be overused. Resources are wasted because the cost of providing the services will inevitably be higher than its value to the marginal user.

I think it is unfortunate that the Federal Reserve is in a position that it must offer free services to member banks to partially offset the cost of the nonearning balances they must keep with us as reserves. I think both the Federal Reserve System and the commercial banking system would operate more efficiently if they paid depositors a market rate of interest on their deposits and charged for services on the basis of the costs incurred in providing those services.

In any industry in which price competition is constrained, competition takes the wasteful form of giving away free services. And the more competitive the industry, the more waste is generated. We saw this in the brokerage industry before fixed pricing was abolished. We see it now in the commercial banking industry, where the more competitive the market, the more institutions compete by offering free services or other amenities which cost more than their value to the consumer. The free checking account is one common example. The proliferation of expensive branches is another.

Now when banks are charged for Federal Reserve services, they will use these services more sparingly. In some cases they may do more processing of the checks themselves, or they may set up local clearing associations in which they simply swap checks among themselves, avoiding the Federal Reserve System altogether.

To the extent that such services can be performed outside the System at a lower cost, this private market development would simultaneously save money for the public and reduce a heavy check burden which the Federal Reserve now bears. Thus the introduction of pricing would improve the efficiency of the Nation's payment system.

Pricing of services will also increase efficiency by reducing the use of checks as a means of payment. It will also hasten the rate at which substitutes for checks are introduced. At present the public shows no great enthusiasm for innovations, such as electronic funds transfer systems, since the present costly system of paper checks is provided at low charge. However, if customers were charged the cost of check processing, the relative cost and convenience of electronic funds transfer would become more attractive. Unfortunately the System cannot introduce pricing for its severance until the burden of membership is eliminated.

Thus, the membership problem not only creates obstacles of increasing significance for the efficient conduct of monetary policy, but it also blocks the way toward a more efficient and less costly banking system for the American public.

Thank you, Mr. Chairman.

[Mr. Morris' prepared statement follows:]

Statement of

Frank E. Morris

President of the

Federal Reserve Bank of Boston

before the

House Committee on Banking, Finance and Urban Affairs

Washington, D.C.

I appreciate the opportunity to testify on an issue which has great long-run consequences for the efficient conduct of monetary policy and the stability of our banking system. I propose to limit my remarks to two principal areas: (1) the Federal Reserve System's membership problem, how it has come about, why it is a problem and what can be done about it, and (2) the issue of charging for Federal Reserve services--why it will be publicly beneficial once the membership burden has been eliminated.

Membership Burden

While membership in the Federal Reserve System entitles banks to receive free services provided by the System, member banks are required to hold reserves against demand and savings and time deposits either as vault cash or as deposits with Federal Reserve Banks. Non-member banks are permitted by state authorities to hold most of their reserves as earning assets or in the form of balances which the normal course of business would require. Historically, the Federal Reserve has not paid interest on reserves held by member banks, so that membership involves a cost equal to the interest foregone on the non-earning balances held at the Federal Reserve.

The difference between the value of the services received and the interest foregone equals the net burden of membership. If the member bank gives up more in interest revenue than the value of services it receives, then it may be to the member bank's advantage to withdraw from the System and purchase these services from a

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correspondent. Over the past ten years the net burden of membership has increased sharply as a consequence of the inflation-connected rise in open market interest rates. For all member banks it is estimated that the net burden of membership is about 9 percent of 1977 before-tax income. For banks in the $100 million to $1 billion deposit size class, where the most serious erosion of membership has occurred in recent years, the net burden is estimated at 10 to 12 percent of pre-tax earnings.

The net burden associated with membership in the Federal Reserve System is in effect a Federal franchise tax which member banks must pay but which non-member banks can avoid. Since the Federal Reserve System is the only central bank with voluntary membership, banks can avoid this Federal franchise tax by relinquishing their membership. When Congress passed the Federal Reserve Act it neither foresaw nor intended that Federal Reserve membership would involve a substantial financial burden. The goal of the present legislative package should be to adjust benefits and costs so that the Federal Reserve membership decision will not involve either a net burden or a windfall gain.

Decline in Membership

During 1977 11 banks in New England and 58 banks in the rest of the U.S. withdrew from the Federal Reserve System. These 11 banks accounted for about 5 percent of the total number of member banks in New England and had deposits of more than 10 percent of total deposits held at all member banks. By the end of 1977 the proportion of insured commercial bank deposits held by member banks had fallen below 63 percent in New England and 75 percent elsewhere, which compares with figures of 77 percent and 79 percent, respectively, at the end of 1972.

In the past, the membership problem has been largely restricted to small banks; but this is no longer the case. During 1977, 8 of the 11 banks which left the System in New England and 7 of the 58 banks which withdrew in the rest of the United States had deposits of $100 million or more. Among them, these 15 banks had total deposits of $3.3 billion.

We have discussed the burden of membership in an open and frank manner with our members in New England and attempted to impress upon them that the System intended to seek Congressional action to alleviate the net burden. As a result of these discussions many banks have temporarily postponed their decision pending the outcome of legislation. Thus far in 1978, only three New England banks have announced target dates for withdrawal. However, an additional 34 banks have indicated that they are seriously considering withdrawal from membership. Of these 34 banks, 14 have deposits of $100 million to $500 million, and three have deposits of over $500 million. Together the 37 banks have deposits of $5.3 billion and account for almost 28 percent of deposits held by all member banks in New England. These banks currently keep $273 million in reserves with the Federal Reserve Bank of Boston upon which we earned (and turned over to the Treasury) almost $18 million in 1977.

If no action is taken, it is probable that by the end of 1979 Federal Reserve member banks will hold less than half of all commercial bank deposits in New England.

The rate of withdrawal by member banks is substantially greater in New England than elsewhere, although the trend is accelerating around the country. The higher rate of withdrawal by member banks in New England is due to several factors. First, because of aggressive competition from well-established thrift institutions, commercial banks in New England have difficulty in attracting time and savings deposits and as a result tend to have higher ratios of demand deposits to total deposits than do banks in the rest of the country. Because the impact of reserve requirements falls mainly on demand deposits, the net burden of membership is relatively larger for New England banks of a given size than for equivalent banks elsewhere.

A second factor responsible for the greater exodus in New England is the impact of NOW accounts and the related fact that thrift institutions, unlike their counterparts in most other sections of the country, can offer full service banking to the consumer.

The intensified retail banking competition has resulted in lower profit margins for New England bankers. For example, in 1977, net income before taxes and securities transactions as a percentage of total assets was 0.76 percent in Massachusetts. The corresponding figure for commercial banks nationally in 1977 was 1.09 percent--more than 43 percent greater. This relatively weak earnings performance has generated pressure to increase earnings by leaving the Federal Reserve and avoiding the Federal banking franchise "tax." All of the New England banks that have left the System have done so reluctantly, but the pressure of the "bottom line" has been just too great.

Why Declining Membership is a Problem

The erosion of membership worries me, because the System's very reasons for existence are being threatened.

The membership problem impairs the ability of the Federal Reserve to conduct monetary policy with the precision we are seeking. Every time a bank leaves the System our information base on deposits shrinks, the reserve base shrinks relative to the deposit base and the reserve multiplier (the relationship between a change in reserves and a change in deposits) will become more unstable. In an era when precise control of the money supply is given more importance than ever before, the membership problem is weakening the ability of the Federal Reserve to execute monetary policy.

In addition, the banking system is rendered more vulnerable and the ability of the economy to withstand financial shocks is lessened by the fact that an increasing proportion of banks do not have access to the discount window. In recent years the development of sophisticated techniques of liability management have lessened the importance of the discount window as a routine source of liquidity, and many banks leaving the System believe that if need should arise they will be able to obtain liquid funds from their large correspondents. In the normal course of events, there is no doubt that the large banks will be able to meet the liquidity needs of their smaller correspondents. But if a general liquidity crisis should occur, the large banks may not be able or willing to meet the needs of all non-member banks. Even if they have the funds available or are able to obtain them from the Federal Reserve, the large banks may be reluctant to assume the substantial credit risks involved in numerous large scale advances to their correspondents.

It should be remembered that the original impetus to the formation of the Federal Reserve was the failure of the correspondent network to provide adequate liquidity to country banks during the financial crises of the early 1900s. The Federal Reserve is the only lender that can unconditionally guarantee a sufficient supply of funds in times of crisis, but performance of this guarantee requires a direct relationship between the Federal Reserve and the borrowing bank. The decline in membership thus endangers the performance of a Federal Reserve function which is only of routine importance presently but whose successful implementation in time of crisis is imperative.

Two Solutions

There are fundamentally two ways of dealing with the problem. One way is to mandate uniform reserve requirements, placing all financial institutions on an equal footing. If the Congress remains unwilling to do this, then it should approve the only alternative solution--to eliminate the excessive burden of membership in the Federal Reserve.

The proposal made by the Board of Governors to reduce the membership burden by a combination of reserve requirement reductions and interest payments on reserve balances will solve the problem at little or no cost to the Treasury in the long run.

In my judgment the Board's cost estimates are much too high, since they make no allowance for the effect of increased membership. There is no doubt in my mind that if the Board's program were adopted, most of the New England banks which left the System would rejoin promptly, along with many commercial banks and some savings banks which have never been members. In the long run, I believe that the cost of the Board's program to the Treasury will be less than the cost to the Treasury of doing nothing and suffering the declining revenues produced by a continued decline in membership.

Service Charges

I would like to turn now to the issue of the pricing of Federal Reserve services. It is an economic truism that any costly service provided free of charge will be overused. Resources are wasted because the cost of providing the service will inevitably be higher than its value to the marginal user. It is unfortunate that the Federal Reserve must offer free services to member banks to partially offset the cost of the non-earning balances they must keep with us as reserves. Both the Federal Reserve and the commercial banking system would operate more efficiently if they paid depositors a market rate of interest on their deposits and charged for services on the basis of the costs incurred in providing those services.

In any industry in which price competition is constrained, competition takes the wasteful form of giving away free services--and the more competitive the industry the more waste is generated.

We saw this in the brokerage industry before fixed pricing was abolished. We see it now in the commercial banking industry where the more competitive the market, the more institutions compete by offering free services or other amenities which cost more than their value to the consumer. The free checking account is one common example, the proliferation of expensive branches another.

For example, New England commercial banks have attempted to compete with one another by increasing the number of banking offices to offer greater convenience to the customer. As a result, total deposits at commercial banks in New England were only about $13.3 million per office at the end of 1977 compared to $20.6 million per office in the rest of the country. The effect of these lower deposits per office is to increase substantially operating costs per dollar of deposits. In 1977 the non-interest expense per dollar of assets at New England commercial banks was almost 26 percent higher than for banks in the rest of the country. Ultimately, these higher costs must be borne by the consumer.

When banks are charged for Federal Reserve services, they will use those services more sparingly. In some cases they may do more processing of the checks themselves or they may set up more local clearing associations in which they can simply swap checks among themselves, avoiding the Federal Reserve System altogether. To the extent that such services can be performed outside the System at a lower cost, this private market development would simultaneously save money for the public and reduce the heavy check burden which the Federal Reserve now bears. Thus, the introduction of pricing would improve the efficiency of the nation's payment system.

Pricing will also increase efficiency by reducing the use of checks as a means of payment. From 1972 to 1977 the number of private checks processed by the Federal Reserve System increased from 8.4 billion to 13.3 billion or by 58 percent. This rapid growth in the use of checks has imposed substantial costs on both the commercial banks and the Federal Reserve System. If depositors were charged for each check written, future growth in the volume of checks would be substantially reduced (especially in checks for very small amounts), with significant savings for both the commercial banks and the Federal Reserve System.

Pricing will also hasten the rate at which substitutes for checks are introduced. At present, the public shows no great enthusiasm for innovations such as electronic funds transfer systems, since the present system of paper checks is provided at no charge. However, if customers were charged the costs of check processing, the relative costs and convenience of EFTS would become more attractive.

Pricing would also eliminate another deficiency in the structure of the Federal Reserve System. As matters now stand any bank which requires few System services pays the same membership fee in terms of lost earnings on reserves as does a bank of the same size which uses many System services. Thus, a large member bank with a small correspondent business now carries a much larger net burden than does a member bank of the same size with a large correspondent business. If the System membership package could be unbundled so that member banks were required to pay for all the services they receive, we would create a much more equitable and logical system.

Unfortunately, the System cannot introduce pricing for its services until the burden of membership is eliminated. The membership problem not only creates obstacles for the efficient conduct of monetary policy but it is blocking the way toward a more efficient and less costly banking system for the American public.

The CHAIRMAN. Thank you, Mr. Morris.

I am not going, Mr. Sprinkel, to address any specific question to you because I find your whole testimony very persuasive—where we agree, I naturally find it persuasive; where we don't, I am most interested in what you have to say. I am going to reconsider my thinking.

Mr. Morris, you base your proposition that congressional action should be taken to halt attrition in the Federal Reserve membership system largely on two grounds: Ground No. 1, you say that every time a bank leaves the System, our information base on deposits shrinks.

My question: Couldn't we solve this monetary control and information problem simply by authorizing the Federal Reserve to collect whatever information it needs on the deposit liabilities and assets of nonmember institutions? Wouldn't this be a simpler and more effective way than doling out hundreds of millions of dollars in taxpayer's money in order to induce nonmember institutions to join the Fed?

In this connection, I am very sympathetic to the suggestion made by Mr. Sprinkel that maybe the paperwork costs that you would put to depository institutions in making these reports should be borne by the Government, they should be reimbursed. I think that would be fair.

Putting that to one side, you can achieve monetary control without a compulsory or semicompulsory or heavily subsidized membership, can't you?

Mr. MORRIS. Well, it is a question again of the degree of control. I think information is one of our problems. It is not the only problem. The Committee, the Federal Open Market Committee, found out in March, for example, of this year, that the money supply, M_1, grew at about half of 1 percent faster than we had thought it had grown. I find this kind of information gap in our system completely inexcusable.

The CHAIRMAN. Mr. Sprinkel had a couple of suggestions, lag reserves and daily, rather than 1 day a week, reporting, which I think in the future could help. I was cheered that Chairman Miller the other day indicated that the day of lag reserves is nearing its end, it will not be missed, as far as I am concerned.

Mr. MORRIS. I have been an advocate of eliminating the lagged reserve procedure within the System. I think we ought to move ahead on that. I haven't seen sufficient study of the proposition to have various banks end their weeks on different days to know what problems that might occasion. But on the surface, my initial impression is that it might not be a bad idea. Until it is studied carefully, I really couldn't take a position. I think you are overlooking some of the other problems I raised. I am very much concerned about the growing inability of the Federal Reserve to deal with a large-scale liquidity crisis in this country.

The CHAIRMAN. That was the second point I was going to come to, in which you say that, and I am quoting you "an increasing proportion of banks don't have access to the window," and that this may be all right on a sunny day. You then go on to say that, if a general liquidity crisis should occur, the large banks may not be able to or willing to meet the needs of all nonmember banks.

Since you have raised it as your second point and came out for it quite strongly in your testimony, let me ask my question on that.

Suppose you have this general liquidity crisis, God forbid, but suppose we do. The Federal Reserve under its present authority could open its discount window directly to nonmember institutions, it could exercise that authority.

Wouldn't the affected nonmember banks quite eagerly pay the penalty rate of interest in order to maintain the liquidity necessary to their survival?

If so, and I believe that is so, what is the problem? Why shell out half a billion dollars a year just to keep up the membership in the country club?

Mr. MORRIS. First of all, with respect to your half billion dollars, Mr. Chairman, I personally feel that the Board's proposals wouldn't cost the Treasury a nickel because I think in the absence of some action by the Congress the erosion in membership is going to continue, and with the erosion in membership will go a decline in revenue to the Treasury which I think is going to be quite commensurate with any cost of the System's proposal.

The CHAIRMAN. It is interesting to note, though I don't want to divert, that just the other day Chairman Miller testified that higher interest rates were a big, big factor in the tendency toward erosion. That is plausible enough. The higher the interest rate, the more you lose by sterile deposits. Then he gave us the good news that interest rates were going to come down.

Well, if so, you might be getting some members without raising a finger.

Mr. MORRIS. Well, I would like to think they are going to come down far enough to deal with the membership problem, but I think that is highly unlikely in the foreseeable future. On this issue of lending to nonmembers, the problem, Mr. Chairman, is the speed with which we can react.

I have the authority to make loans to members quickly without reporting what I am doing to Washington until after the fact. We send weekly, monthly, and quarterly reports to the Board. If they think we are doing something wrong, they will let me know about it. I don't have to come to Washington for authority to lend to a member bank. We can move very rapidly. But under the present law to make a loan to a nonmember institution, I have to come to Washington and get five of the seven Board members to approve that loan.

Now we are talking about a very time-consuming proposition. And there are occasions when I might not even be able to find five of seven Board members. I am talking about a situation in which it is imperative, for the health of the economy, that the Reserve banks be able to move quickly in putting money into the places where that money is needed.

Now another reason I think that would cause delay is that we know what is going on in our member banks. We keep weekly charts, showing what happened to their loans, investments, Federal funds position, so on. So if we see a bank with a liquidity problem on the horizon, we are alerted to it in advance. We know the condition of the bank; it is not a surprise to us.

On the basis of that knowledge, we can talk to the bank well before it gets into a critical position. If it is a nonmember institution, we probably wouldn't even be advised until it is about to go down the chute. I don't think I, as a public official, can lend Government money to an institution about which I know practically nothing just like that.

The CHAIRMAN. Of course, the amendment backed by such of our members as Mr. Vento, Mr. Lundine, just to name two of them, imposes a rigorous mandate on the Fed to go get that information on nonbanking institutions. I think you do a good job on banks, but increasingly, as has been pointed out plenty of times, quasi-banks, known as municipal savings banks, savings and loans, and credit unions are creating money. We must have some method. You and the Board of Governors here need some help, which we intend to give you.

My time is almost up. I would however ask Mr. Sprinkel if he cares to comment on either of the points made by Mr. Morris, either what do you do about the liquidity point or the earlier point.

Mr. SPRINKEL. Well, if I could add one statement, clarifying statement. I don't want to be interpreted as saying that membership in the Federal Reserve is trivial, and therefore we should do nothing to keep it. I do not like to see specious arguments used for justifying getting all the banks into the System.

The point that I made was that we can regulate the money supply without required reserves. That does not convince me, however, that, as a practical matter, we should encourage continued attrition in the membership of the Federal Reserve System. They perform some very important roles, and one of them I think is probably overriding. I think it is very important politically that we have strength and support behind a central bank who has some independence from the Congress, from the administration, within Government, and membership in the Federal Reserve probably will strengthen that independence. So I just want to make sure that you didn't understand me to say that Mr. Morris is worrying about trivial matters. I don't think you were.

The CHAIRMAN. I don't think anybody would have thought that, but it is very clear now.

Mr. Pattison.

Mr. PATTISON. I am not a banking expert, so you will pardon my ignorance in some of my questions.

But isn't the major reason for reserve requirements, whether they be deposited in sterile accounts or whether they be required to be maintained and set aside, that is simply a matter of safety for the depositor; is that not correct?

Mr. MORRIS. I think that was some of the thinking in the original act. But actually since we require all banks to keep those reserves with us, week in and week out, it is not really a liquidity reserve for the banks. It is a fulcrum for monetary policy, but it is not liquidity for the bank.

Mr. PATTISON. Isn't the problem one that if you don't have some reserves, whether you keep them in a shoe box or keep them in the Federal Reserve, that you can find yourself with a liquidity crisis quite rapidly and that that is the main reason for the reserves?

Mr. SPRINKEL. Unfortunately, the most illiquid asset on the balance sheet is required reserve with the Fed. The only way to get those reserves is to go out of business.

Mr. PATTISON. But if under the State banking system you are just simply required to have a certain amount of assets in treasuries, or whatever else they require you to have them in, that isn't illiquid, you can realize that very quickly.

Mr. SPRINKEL. Yes.

Mr. PATTISON. That would solve the safety problem if we simply required all financial institutions, banks, thrifts, savings and loans, anything else, to maintain a certain amount of reserves in their own way, regulated perhaps but invested themselves, as opposed to being put in the Reserve System.

Mr. SPRINKEL. Self-survival will insure that. They must have adequate resources to meet drains, to meet transfers of funds. You may want to require it, too. But required reserves does not perform that function.

Mr. PATTISON. Required reserves in the——

Mr. SPRINKEL. In the form of deposits with the Fed.

Mr. PATTISON. But required reserves otherwise would——

Mr. Sprinkel, would you require reserves to be held by all institutions, not in the Fed, but just simply some set-aside safety factors to be held by all institutions?

Mr. SPRINKEL. With the Fed?

Mr. PATTISON. No, no.

Mr. SPRINKEL. They all have requirements of one kind or another, either State requirements——

Mr. PATTISON. Isn't one of the problems really that the dual banking system says the States regulate certain kinds of institutions or certain institutions, and the Federal Government regulates other institutions? There is an imbalance sometimes because you hold sterile reserves in the Federal Reserve System and not sterile reserves in the State system. So you have a competition between the two systems.

Mr. SPRINKEL. That is correct. Those banks that must set aside assets on which they get zero return bear a tax that the other institutions do not, and that tax gets passed on to you and me who use the banking services.

I might add, incidentally, that one of the advantages, relating back to Mr. Annunzio's initial question of reducing reserve requirements, that I believe that most of those temporary benefits or profits that appear initially will get competed away. That is why I am in favor of paying demand deposit interest. It is the public who will benefit from this move, not the banking industry.

Mr. PATTISON. How does that occur in the light of the dual banking system, or can it? How would we require that?

Mr. SPRINKEL. You mean if you continue to have some bank members of the Fed and others that are not members?

Mr. PATTISON. Suppose we took out of the Fed membership the requirement that you hold reserves in the Fed but required just reserves to be held, as many of the State institutions do, in separate instruments.

Mr. SPRINKEL. That would reduce the differential tax, it would eliminate it. The Federal Reserve might well argue they couldn't control the money supply with zero reserve requirements.

Mr. PATTISON. That is the next question.

Mr. SPRINKEL. But I don't agree with that.

Mr. PATTISON. At that point the Fed has two problems, one it has no money that it can use to——

Mr. SPRINKEL. Federal Reserve's ability to acquire assets is not a function of how many deposits we have with them, even though many bankers believe that is true. It really isn't true. They have unlimited authority to expand money.

Mr. PATTISON. By open market, buying Treasuries and selling Treasuries?

Mr. SPRINKEL. Yes, that is correct.

Mr. PATTISON. All right. So your point is that they don't need those sterile reserves to be held at the Fed.

Then that would give them a problem, would it not, with the discount window? From where would they get the money to lend in a discount window?

Mr. SPRINKEL. Same place they get the other money, create it.

Mr. PATTISON. That is what I thought. Therefore the point that Mr. Morris makes is that because there is a lot of people who are not able to get to the discount window because they have gotten out of the Fed, could be resolved by simply making the Fed discount window available to them. Obviously the point he further makes is he doesn't want it to be available to them unless he knows something about them.

Couldn't that be solved in the same way that you solve your requirements with the Fed members now?

Mr. MORRIS. Yes. But to the extent we make the discount window available to nonmembers as well as members then you have created another reason for members to leave the System. That is a very important reason why banks do not leave the System.

Mr. PATTISON. Except it is possible you could pay, as suggested by the chairman, you could require nonmember banks to pay a premium and that would be a disincentive to get out of the Fed.

Mr. MORRIS. Yes. But that premium would look pretty small, no matter how big it was. It would be pretty small against the cost of maintaining noninterest bearing reserves with us.

Mr. PATTISON. Then I suppose you could say that everybody has to have the availability of the discount window and everybody pays a certain amount for that privilege, whether you are a member of the Fed or not, that would accomplish the same thing, would it not?

Mr. MORRIS. I think something could be structured along those lines, yes.

Mr. PATTISON. I might point out, Mr. Morris, that Chairman Miller doesn't take the same position that you do about the increase of membership to the Fed. He says that these proposals are not intended to attract new members and he says "I don't think the proposals would attract members." And then Mr. Campbell, who testified before you, agrees with that also, and he says that the proposals, since they provide the heaviest burden—since the heaviest burden of membership falls on the small banks, the payment of interest on reserves would redound primarily to the large banks. He says explicit pricing would discourage small banks from becoming members because they get a better deal with correspondent banks. And the discount window, the only unique service provided by the Fed isn't sufficient inducement to get people to go in. So he would differ with you also on whether or not the proposals would attract new members to the Fed.

Mr. MORRIS. Yes. I certainly differ with him in that respect. On the basis of my exit interviews, I think every one of the banks we lost last year would be willing to come back into the System if this package that the Board has proposed were to take legislative form. In fact several of them told me explicitly that they feel that sooner or later the Congress will have to do something about this membership problem, and that when Congress does, they will be back in, but in the meantime they will have increased their earnings for several years.

Mr. PATTISON. Thank you.

My time has expired.

The CHAIRMAN. Mr. Vento, could I ask you to be kind enough to act as chairman for the remainder of the session?

Permit me to thank Mr. Sprinkel and Mr. Morris for very constructive testimony.

Mr. VENTO. Thank you, Mr. Chairman. I think I can function from here. I am the last one to ask questions and I too have to make the recorded vote. I will try to be as brief as I can.

I looked over both of the testimonies.

Mr. Sprinkel, I think that Representative Pattison was looking at a significant factor here in terms of talking about the other types of reserves that might be required by States or by the FDIC or whatever the regulatory mechanism is for the financial institutions.

Has anyone looked at that in a comprehensive manner that you can report to us; or for that matter, Mr. Morris, has anyone looked at these particular reserves to determine how sterile they are, what the earnings are?

What I am suggesting is that one of the purposes of these hearings is to look at the eroding membership of the Fed.

What is the competition doing which is causing the competition to take place; how sterile? What is the rate for the required reserves, of all the reserves, or however they are held?

Mr. MORRIS. Well, there are some differences among the States.

Mr. VENTO. I understand that. But I realize this has to be a general answer, but someone must have looked at that.

Mr. MORRIS. Yes, we have.

By and large, I think it is true that the State reserve requirements impose no net burden to the State-chartered nonmember banks, because they permit the reserves to be satisfied by either income-earning assets or non-income-earning assets that the bank would have to hold in the normal course of events. That is, a bank has to hold some cash. A bank does have at any one point in time claims on other banks through the check claim process. These can be counted as reserves in most States.

So that I think the short answer to your question, sir, is that there is, by and large, no burden of reserve requirements for nonmember banks.

Mr. VENTO. I see nodding approval. I assume that is agreement.

Mr. SPRINKEL. Yes.

Mr. VENTO. On page 4 of your statement, Mr. Sprinkel, you point out that you disagree with apparently the lowering of reserve requirements, not the lowering but the complete removal from smaller banks, and you suggest that if it is our desire to help smaller banks, that there are other means that would be more efficient.

What, for instance?

Mr. SPRINKEL. The reason I argued that is that if they have zero reserve requirements and other banks have higher reserve requirements, the movement of deposits from one category to another creates more noise in the System and makes it more difficult for the Federal Reserve to predict what the effect of a given action will be on the money supply.

I don't know, you can do it with taxes, you can have lower marginal tax requirements on smaller banks. There must be a multitude of ways that do not monkey with the money multiplier. Because the real purpose of the Fed, the major purpose, is to conduct a stabilizing monetary policy. Things that get in the way of it, I would like to find ways around them.

Mr. VENTO. The other point on page 2, you recognize demand deposit problems.

What is your attitude with regard to the different reserve requirements the Fed proposes for transaction accounts as opposed to demand deposits?

Mr. SPRINKEL. Well, I have the same argument, that is, we have a large multitude of varied reserve requirements now. And if you add to that an additional one, it will make the matter of predictions that much more difficult.

Now the Fed obviously doesn't believe that is important, because we have had a tendency in recent years toward greater differentiation in various kinds of marginal reserves. I think it makes it more difficult to regulate and predict the money supply.

Mr. VENTO. Putting on two different requirements, you think, is a mistake in terms of reserve requirements for transactions versus demand deposits?

Mr. SPRINKEL. Yes, sir.

Mr. VENTO. Mr. Morris, we had quite a discussion. Representative Oakar asked a question regarding what the cost of the Federal Reserve's plan was. You raised the same question today in a very forceful manner.

The basis for the argument that the Fed put forward is the plan will attract new members and actually not cost anything. As you have observed, the plan provides banks with $5 million or less in deposits will have no reserves held by the Fed. These new members will hold required reserves that they did not hold before. These required reserves are viewed as a tax on commercial banks, both of you say, a tax equal the income they would have earned if they were to invest this money in income-earning securities such as Treasury bills.

Without going through the argument any further, let me say why I think it is a wrong argument which obscures the fact that the Fed is asking for authority to increase expenditures by hundreds of millions of dollars in perpetuity.

A bank joins the Federal Reserve and gives up its nonmember status, agreeing to hold costly, sterile reserves only because its aftertax income will rise under the Federal Reserve plan to pay interest on reserves. The banks simply must earn more on its required reserves than it was able to earn on these funds when it was a nonmember bank or it will not change to membership status. The subsidy must be bigger than the tax, and this is true of every bank that enters the Fed and of all the banks entering the Fed taken together. It must cost the Fed more than it takes back in taxes for the Treasury or the banks won't change to membership status.

Economists tell us that if you transfer real resources to member banks, someone must pay.

Is it the Treasury which receives lower taxes?

I would like Mr. Morris to fully explain why he thinks the Fed proposals would be costless if enough new members join the Fed.

I would say that if you lose tax revenues on the net subsidy required to attract one member, you don't increase total tax revenues with higher volume.

Please begin, Mr. Morris, by telling me how a nonmember bank with less than $5 million deposits, which would be exempt from reserve requirements under the Fed plan, would increase the Treasury's tax revenues by changing the membership status?

I would also like Mr. Sprinkel to comment on this.

Mr. MORRIS. Obviously, that particular bank would not, but the problem that we have had with membership, particularly in New England lately, and the thing that disturbs me most is the fact that we have had very large banks, banks from $100 million to $500 million deposits, leaving the System.

I think under our proposal those large banks, particularly around the $1 billion mark, would still have some net burden of membership. And there would be this half of 1 percent differential between the interest we paid out and the interest we have earned. So there would be a net gain financially to the Treasury.

In addition to that, if we don't do something, the Board has estimated that 4 years out our Treasury revenues will be from $80 million to $200 million less than they are today, because of additional departures of memberships from the Federal Reserve.

This business of lost membership is just getting started. Bankers are very conservative people. They like to do what they are expected to do. They like to do what is in good form. In the past it has been considered good form for a bank of any size to be a member of the Federal Reserve System. That concept is breaking down in New England where it is now considered perfectly good form for a $500 million bank to leave the System, and I think that new mores among bankers is going to spread around the country.

When this happens, the loss to the Treasury from nonmembership is going to accelerate.

Mr. VENTO. Mr. Sprinkel?

Mr. SPRINKEL. Well, this is an empirical issue which I think we really won't know until we try it. However, the direction of change is in the correct one.

We know when a member bank drops out of the System, the reserves in the System in the first instance remain the same but required reserves go down, which means there are excess reserves in the System, and the Federal Reserve then has to liquidate some of its assets if it wants to hold the same degree of monetary stringency.

Conversely, when they come in the opposite occurs. So that we know at the beginning of this particular system there will be reduced earnings for the Treasury. There is no doubt about it. The question is will other banks either not drop out that would have, or new ones that are out come back in.

I suspect that I think Mr. Morris is right when he says that some banks will stay in the System even if it does cost them net. There is a certain prestige to being a member of the Federal Reserve System.

So, I don't think you have to get it down to zero cost to get a lot of them to stay. As they come back in, this, of course, will add to the holding of the Government securities by the Federal Reserve, and their earnings will go up.

Whether the initial deficit will eventually be offset by some gain later, I don't know.

Mr. VENTO. I am almost out of time. I have to run over to vote. I don't want to hold you here beyond that. I have a number of other questions I will submit in writing.

On this point, I am going to have to adjourn the meeting, and I will submit additional questions in writing.

The chairman asked me to announce we are adjourning until 9 a.m. Friday, August 4, and will continue the hearings on this topic.

The committee stands adjourned.

[Whereupon, at 1:05 p.m. the committee adjourned, to reconvene at 9 a.m., Friday, August 4, 1978.]

MONETARY CONTROL AND THE MEMBERSHIP PROBLEM

FRIDAY, AUGUST 4, 1978

HOUSE OF REPRESENTATIVES,
COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS,
Washington, D.C.

The committee met, pursuant to notice, at 9 a.m., in room 2128, Rayburn House Office Building, Hon. Henry S. Reuss (chairman of the committee) presiding.

Present: Representatives Reuss, Moorhead, Gonzalez, Hanley, Mitchell, AuCoin, Derrick, Cavanaugh, Vento, Watkins, Stanton, McKinney, Hansen, Hyde, Kelly, Grassley, Fenwick, Leach, and Green.

Mr. MITCHELL. Today we continue our hearings on the efficiency of monetary control and Federal Reserve membership.

We have before us three bills and an amendment to one of these bills: H.R. 13476 and H.R. 13477, the Federal Reserve proposals submitted by request; H.R. 12706, the Stanton bill, and an amendment to the Stanton bill.

Our witnesses today will be: the Honorable George LeMaistre, Chairman of the Federal Deposit Insurance Corporation; Parke W. Wicks, president and chief executive officer, First Trust & Deposit Co. of Syracuse, N.Y.; Harry E. Leonard, bank commissioner, State of Oklahoma, representing the Conference of State Supervisors and accompanied by Dr. Lawrence E. Kreider, executive vice president-economist of the conference; and John Perkins, president, Continental National Bank and president-elect of the American Bankers Association, accompanied by Leif Olsen, chief of the economic policy committee of Citibank, New York, N.Y.

I have several brief announcements to make. The House is now in session. The Congress does work. We started at 9 a.m. this morning. However we have obtained permission to continue the hearings during the time the House is in session. We hope to finish up the other 50-some amendments on the foreign aid bill today.

I yield briefly to my distinguished colleague, Mr. Hanley, for a statement at this time.

Mr. HANLEY. Thank you very much, Mr. Chairman. We are delighted to have this distinguished panel before us. I am confident the testimony they offer this morning is going to be of immeasurable assistance to this committee as we deliberate this rather important subject matter.

I would be less than candid if I didn't say I am especially delighted to note at the table my dear friend and constituent, one who has long been associated with the commercial banking industry and one who many regard as a national expert on the subject matter, Parke W. Wicks.

Mr. Wicks, it is good to see you here this morning. I am delighted that you saw fit to respond to the invitation of the committee to appear. Having good knowledge of your background, I am confident that what you say is going to be very meaningful. I am sure that will apply to all of the other members of the panel also.

Just one final note. I am sorry to be advised that this will be Chairman LeMaistre's swan song. I extend to you my personal appreciation for your many courtesies and certainly throughout your tenure your contribution has been invaluable. The best to you as you proceed through the future.

Thank you, Mr. Chairman.

Mr. MITCHELL. Mr. Hyde, you are the ranking minority member. Do you have an opening statement?

Mr. HYDE. I have none. I associate myself with the remarks of yourself, Mr. Chairman, and with Mr. Hanley and I welcome the distinguished panel, particularly Mr. Perkins from my hometown.

Mr. MITCHELL. I thought we would proceed by calling on Chairman LeMaistre.

Chairman LEMAISTRE. I will summarize my statement. I will ask the entire statement be included in the record.

Mr. MITCHELL. Without objection.

STATEMENT OF HON. GEORGE A. LeMAISTRE, CHAIRMAN, FEDERAL DEPOSIT INSURANCE CORPORATION

Chairman LEMAISTRE. I appreciate the opportunity to testify before this committee and to present the FDIC's views on the Federal Reserve Membership Act of 1978 introduced by Mr. Stanton and the amendment to this bill that has been proposed by Chairman Reuss.

During the course of this statement, I shall also discuss the FDIC's views on the Federal Reserve Requirements Act of 1978 and the Interest on Reserves Act of 1978, both introduced at the request of the Federal Reserve System, and the Monetary Policy Data Improvement Act of 1978.

I should point out at the outset the Comptroller of the Currency, John Heimann, a member of the FDIC Board, has not had an opportunity to review this statement. The other two members of the Board have agreed on it, but Mr. Heimann has really not seen it.

For the most part, the proposals contained in these bills seem to grow out of the Federal Reserve's concern with declining membership. There has been a slow but steady erosion of Federal Reserve membership over the last 10 or 12 years and banks continue to choose to leave the System.

Recently this gradual decline has accelerated.

Let me begin by stating our view that the legal requirement that the Federal Reserve member banks maintain sterile reserves is inequitable to them and inequitable to their customers.

In many States it places member banks at a competitive disadvantage, vis-a-vis nonmember banks, and the several bills which are under discussion propose two solutions. The first is to establish universal reserve requirements for all banks or depository institutions and the second is to pay interest on reserves to reduce reserve requirements and to charge banks for Federal Reserve services which are now provided free to member banks.

We strongly oppose the establishment of universal reserve requirements. The alternate proposal is attractive on its face and we think deserves thoughtful and sympathetic consideration, but its implementation is not going to be easy because a redressing of the imbalance between member and nonmember banks does raise many difficult issues. These include notably the issue of changes in the Federal regulatory structure, particularly whether the Federal Reserve should continue to exercise supervisory authority and the issue of regulatory reform, particularly whether interest rate ceilings and the prohibition of interest on demand deposits ought to be abolished.

I will attempt to explain how we reached these conclusions by discussing how these two proposals for dealing with the attrition of Federal Reserve membership bear on several important public policy considerations: First, the capability of the Federal Reserve System to conduct monetary policy effectively; second, the balance between State and national banking systems; third, the efficiency and innovative capacity of the banking system; and fourth, the viability of the banking system under liquidity pressures.

As to monetary policy effectiveness, according to the Federal Reserve System, the Federal Reserve Requirements Act of 1978, H.R. 13476, is intended to provide the basis for more effective monetary control. Furthermore, the Federal Reserve has stated its belief that the decline in the proportion of deposits held by member banks caused by membership attrition adversely affects the precision with which monetary policy can be conducted.

There have been a number of studies of the monetary control issue by economists outside the Federal Reserve and all of those that I am familiar with have concluded that increased Federal Reserve membership and legal reserve requirements are not important to the effectiveness of monetary policy.

The studies are cited in the prepared statement that I am filing, and in the interest of time I won't discuss those studies except to say that the evidence and the opinions on this issue are distinctly one-sided.

Knowing the tendency for economists to disagree, I think unanimity in this case is impressive.

We might conclude that legal reserve requirements and increased membership are not necessary to the conduct of monetary policy.

What the Federal Reserve does need to conduct monetary policy effectively is information about monetary aggregates. We support the proposals that make available to the Federal Reserve summary statistics on assets and liabilities of all depository institutions and reports of deposits and required reserves. We do not believe, however, that the adoption of the Monetary Policy Data Improvement Act of 1978 is really necessary. This proposal would require the FDIC to collect data on deposit and cash items each week from a sample of 1,000 nonmember banks, including all those having deposits over $100 million, and to transmit that information to the Federal Reserve.

Several years ago, the Federal Reserve became concerned about the adequacy of its data on the money supply and established a committee which recommended better and more frequent data on nonmember bank deposits.

Following that report, the FDIC instituted a special schedule in the quarterly call report for all nonmember banks to provide the Federal Reserve with better information on the money supply. This collection was initiated with the spring 1976 call for report of condition.

Also beginning the first week of July 1977, a sample of 580 nonmember banks has been reporting deposit and cash items on a regular weekly basis, the same items as all nonmember banks report four times a year.

The Federal Reserve has indicated that it expects the data from these two surveys to enable significant improvement in their estimates of the nonmember bank component of the Nation's money supply.

In summary, we believe the need of legal reserve requirements for monetary control purposes is not supported by the weight of available evidence. The evidence to date suggests that monetary policy effectiveness depends on adequate data, proper estimation procedures and appropriate open market operations decisions, and not on reserve requirement jurisdiction.

A second broad consideration is the potential impact of these proposals on the dual banking system.

We believe the dual system of State and national banks has been a positive element in the American system of government and has contributed to a more innovative and responsive financial system.

Accordingly, maintaining a balance between the State and national banking systems is a desirable public policy. Nonetheless, we should not maintain a "balance" for the sake of balance. It is clear that Federal Reserve reserve requirements bear heavily on member banks and result generally in such banks carrying more cash than they otherwise would. In direct competition with the nonmember bank, a member bank might be disadvantaged.

One solution to the problem of equity that we believe should be resisted is the proposal to improve universal reserve requirements on the transactions balances of nonmember depository institutions.

If nonmember banks have to maintain reserves at the Federal Reserve just as member banks must do, but have no access or have limited access to the discount window and other system benefits, why not become members?

The assumption is that obligatory universal reserves would not only make nonmembership unattractive, but many institutions would also be inclined to convert to a national charter. Indeed, even the payment of interest on reserves and lowering of requirements might result in a massive influx into the State member and national systems.

If this occurred, many State systems would lose their viability, and the Federal Reserve's and the Comptroller's supervisory authority would have grown substantially without the benefit of congressional consideration.

My point is that the issue of Federal regulatory structure cannot be isolated from this issue of balance. The better of the two proposals—the payment of interest on reserves and lowering of reserve requirements—avoids some serious shortcomings of the universal reserve requirement proposal, but it too may affect the State/Federal balance. The Congress should not allow that issue to be resolved without conscious consideration.

The efficiency of the banking system is a third consideration.

Market pricing encourages competition to improve the quality of goods and services and to lower their cost. Presently pricing is absent in at least three areas that bear directly or indirectly upon the legislation under consideration: First, the absence of interest payments on the required reserves of member banks; second, the provision of services by the Federal Reserve to member banks; and third, the prohibition of interest payments on demand deposit balances and deposit interest rate ceilings.

As a matter of principle, whether to pay interest on reserves should not be an issue.

Presently failure to pay interest is tantamount to the imposition of a tax without calling it that. However, structuring a procedure for paying interest on reserves has raised difficult questions about the appropriate interest rate, concerns about possible windfall gains to large banks, and controversy over what percentage of the Federal Reserve System's revenues should be available for interest payments.

A much simpler approach would be to permit member banks to invest their reserves in interest-bearing securities.

The Federal Reserve could determine what kinds of securities should be eligible for this purpose based on considerations such as risk. This approach would permit each bank to make its own choice and obviate the necessity of having the Federal Reserve establish a rate. Presently 36 States allow State nonmember banks to hold at least part of their required reserves in the form of U.S. Government securities.

Explicitly, pricing Federal Reserve services should increase the efficiency of our financial system by allowing various financial institutions to purchase the services they desire from the Federal Reserve or private alternatives.

The Federal Reserve has stated its opposition to the Stanton bill which it says would require the System to price each service on the basis of costs and a return on capital.

This loss of flexibility would place the System at a significant competitive disadvantage. We are sympathetic to its concern about constraints on its flexibility in setting prices, but are not sure that the Stanton bill would require full cost pricing of each service.

We would recommend that the matter of pricing guidelines receive careful study prior to the enactment of legislation on the issue of pricing to make sure that the Federal Reserve has pricing flexibility without unfair advantage.

Payment of interest on reserves of member banks potentially could place nonmember banks at a disadvantage because the 40-year-old prohibition against the payment of interest on demand deposits does not permit member banks to pay interest on correspondent balances.

These balances often serve as reserves for nonmember banks and serve as well for check-clearing operations and compensation for other correspondent services.

If the principle of explicit pricing is adopted for member banks then parallel treatment would dictate that banks should have the choice of paying interest on correspondent balances and levying explicit charges for correspondent services.

However, if the interest prohibition is lifted for correspondent deposits, it should be lifted for all demand deposits. I have long supported elimination of the prohibition of interest payments on all transactions balances as well as removal of interest rate ceilings on other kinds of deposits.

Finally, I would like to discuss some discount window issues.

The Federal Reserve believes that the ability of the financial system to handle liquidity "crunches" will weaken if membership attrition continues unabated. It should be understood that the decline in Federal Reserve membership does not impair the ability of the System to cope with the kind of generalized liquidity crisis most of us are concerned about, in which the public demands more cash than the banking system holds. Aggressive open market operations and discount window accommodation to members can provide cash sufficient to meet the public's demand.

The decline in membership does impair the ability of the System to minister to a localized liquidity squeeze involving one or a few institutions.

In the past the Federal Reserve has sometimes resorted to conduit loans in such circumstances; that is, loans to a member bank which in turn provides credit to a nonmember institution. We think that the Federal Reserve should accommodate directly a solvent nonmember bank in such special circumstances.

Indeed, we are concerned that membership attrition has contributed to a narrow interpretation of its authority to lend to nonmember institutions in another regard. We believe that emergency borrowings from the Federal Reserve discount window should be available to member and nonmember banks alike upon certification by the FDIC that they are in danger of failing and that such assistance is necessary for a temporary period until a merger, a receivership sale or some other orderly resolution of the bank's problems is arranged. The FDIC, in turn, should be authorized to guarantee the repayment of such borrowings out of the resources of the deposit insurance fund.

The legislative proposals before the committee which address the issue of attrition of Federal Reserve membership raise many of the other difficult issues we have been facing for the past decade—Federal supervisory structure and regulatory reform. The persistent surfacing of these issues is a measure of the need to address them and resolve them. The job of the Congress in this respect is not easy. I hope that my comments will prove to be helpful. Thank you.

[Chairman LeMaistre's prepared statement, on behalf of the Federal Deposit Insurance Corporation, follows:]

Statement on

Federal Reserve Membership Act of 1978 (H. R. 12706),
and Related Legislative Matters

Presented to

Committee on Banking, Finance, and Urban Affairs
U.S. House of Representatives

by

George A. LeMaistre, Chairman
Federal Deposit Insurance Corporation

Mr. Chairman, I appreciate the opportunity to testify before this Committee and present the FDIC's views on the Federal Reserve Membership Act of 1978 (H. R. 12706) introduced by Mr. Stanton and the amendment to this bill that has been proposed by Chairman Reuss. During the course of this statement, I shall also discuss the FDIC's views on the Federal Reserve Requirements Act of 1978 (H. R. 13476) and the Interest on Reserves Act of 1978 (H. R. 13477), both introduced at the request of the Federal Reserve System, and the Monetary Policy Data Improvement Act of 1978 (H. R. 13549).

For the most part, the proposals contained in these bills grow out of the Federal Reserve's concern with declining membership. There has been a slow but steady erosion of Federal Reserve membership over the last decade as banks have chosen to leave the System. Recently, this gradual decline accelerated. Since the beginning of 1977, 108 banks have withdrawn from membership. The percentage of total deposits of commercial banks held by Federal Reserve members has decreased from 83 percent in 1965 to nearly 73 percent at the present time.

The Federal Reserve System has become increasingly concerned about the attrition of membership and the declining proportion of deposits held by member banks. For many years it proposed mandatory membership as a solution. The proposal never received a serious hearing in the Congress for various reasons, but primarily because of the concern expressed by the States about the impact of mandatory membership on the viability of State banking systems. More recently, the Federal Reserve modified its proposal to provide for mandatory reserves and membership privileges for nonmembers.

Last year, as the problem of membership attrition became more acute, the System proposed payment of interest on required reserves and reductions in the minimum statutory reserve requirement limitations. Those proposals were coupled with the Consumer Financial Services Act (S. 2055) which would have authorized depository institutions to offer NOW accounts. In my testimony before Mr. St Germain's Subcommittee on Financial Institutions Supervision, Regulation, and Insurance last year, I stated that payment of interest on required reserves and reduction of reserve requirements as proposed in S. 2055 would have important implications for the competitive balance between member and nonmember banks, and for the structure of the banking system. I indicated that in my judgment these issues are quite complex and are not related to permitting interest bearing NOW accounts on a national basis. Therefore, I recommended that these issues be dealt with separately and be subjected to careful and reasoned study. These hearings and those scheduled before the Senate Banking Committee provide the opportunity for the thorough consideration I think is essential.

Let me begin by stating our view that the legal requirement that Federal Reserve member banks maintain sterile reserves is inequitable to them and inequitable to their customers. In many States, it also places member banks at a competitive disadvantage vis-a-vis nonmember banks. The several bills under discussion propose two solutions: the first is to establish universal reserve requirements for all banks or depository institutions; the second is to pay interest on reserves, to reduce reserve requirements, and to charge banks for Federal Reserve services now provided free to member banks.

For reasons I shall discuss, we strongly oppose the establishment of universal reserve requirements. The alternate proposal, however, is attractive on its face and deserves thoughtful and sympathetic consideration. However, its implementation will not be easy because a redressing of the imbalance between member and nonmember banks raises many of the difficult issues with which the Congress has been wrestling, without resolution, for a number of years. These include, notably, the issue of changes in the Federal regulatory structure, particularly whether the Federal Reserve should continue to exercise supervisory authority; and the issue of regulatory reform, particularly whether interest rate ceilings and the prohibition of interest on demand deposits should be abolished.

In the remainder of this statement I shall explain how we reached these conclusions by discussing how these two proposals for dealing with the attrition of Federal Reserve membership bear on several important public policy considerations: (1) the capability of the Federal Reserve System to conduct monetary policy effectively, (2) the balance between the State and national banking systems, (3) the efficiency and innovative capacity of the banking system, and (4) the viability of the banking system under liquidity pressures.

I. Monetary Policy Effectiveness

According to the Federal Reserve System, the Federal Reserve Requirements Act of 1978 (H. R. 13476) is intended to provide the basis for more effective monetary control. Furthermore, the Federal Reserve has stated its belief that the decline in the proportion of deposits held by member banks caused by membership attrition adversely affects the precision with which monetary policy can be conducted. The point is that as a larger portion of deposits becomes subject to diverse State reserve requirements the linkage between bank reserves and the money supply becomes less predictable.

Of course, estimating the impact on the monetary aggregates of a particular change in reserves becomes more difficult when different banks are subject to different reserve requirements. But this problem would exist even if all banks were subject to universal reserve requirements or if all banks were member banks. Under the present reserve structure of the Federal Reserve, time deposits are subject to different requirements than demand deposits and different size classes of member banks are subject to varying reserve requirements. Hence, a shift of funds among member banks has precisely the same effect of blurring the precision of monetary policy that disturbs the Federal Reserve when nonmember banks are involved. It should be noted that H. R. 13476 would not alter this appreciably, nor would the Reuss amendment which would maintain the present system of varying the percentage of deposits set aside as reserves based on bank size but which would also remove the Federal Reserve's power to change reserve requirements.

There have been several studies of the monetary control issue by economists outside the Federal Reserve. All of those that I am familiar with have concluded that increased Federal Reserve membership is not important to the effectiveness of monetary policy.

There have been two major statistical studies which attempted to ascertain the impact of uniform reserve requirements for nonmember banks on the implementation of monetary policy. The first was conducted by Clark Warburton for the Commission on Money and Credit. Warburton concluded that nonmember banks are affected by Federal Reserve monetary policy actions in approximately the same way that member banks are. Another investigation was reported by Dennis

Starleaf of Iowa State University. In Starleaf's study the actual M_1 money multiplier for the period 1962-1972 was compared with a money multiplier series simulated under the assumption that all banks were subject to the reserve requirements of the Federal Reserve. The simulation indicated that had nonmember banks been subject to such reserve requirements there would have been even greater variations in the money stock. Starleaf thus rejected the argument that uniform Federal Reserve reserve requirements are necessary for the implementation of monetary policy.

There have also been a number of articles that attempted to analyze the logical arguments and the statistical data that exist on this issue. The Hunt Commission concluded that "reserve requirements are unnecessary for open market operations to control the monetary base effectively." Carter Golembe, after discussing the difficulties in conducting monetary policy with precision, concluded that,

> ...so many factors contribute to the lack of precision and certainty that simply changing the proportion of deposits subject to Federal Reserve requirements from almost 80 percent to nearly 100 percent would be of relatively minor importance.

In a 1974 study, Professors Ross Robertson and Almarin Phillips investigated the argument that nonmember banks behave in a different manner from member banks and that such behavior thwarts implementation of Federal Reserve monetary policy. They concluded that these arguments have no validity:

> This contention deluded those who are innocent of money matters and even a few who should know better. As has been observed, open market operations are for all practical purposes the instrument of monetary control. Like the rain from heaven that falls on us all, regardless of

> our merits, open market operations affect member and nonmember banks alike. There is not one shred of evidence to the contrary.

A study conducted by Gary Gilbert and Manferd Peterson at the FDIC found results similar to those of Robertson and Phillips. They concluded that,

> ...the behavior of nonmember banks under varying degrees of monetary ease or restraint is relatively similar to that of country member banks. To the extent that systematic behavior of the demand deposits components is important for the effective control of the money supply, there is no indication from available evidence that the nonmember banking segment has hampered monetary policy.

Some economists have stressed the caveat that the Federal Reserve could control monetary aggregates without member banks or without reserve requirements. For example, in a 1973 article Henry and Mable Wallich stated that,

> Since intermediation [the function of gathering funds from various entities and lending them to others] is a constructive activity, there seems to be no reason why Congress should place burdens upon it beyond those that the tax system imposes on any other form of business. The bulk of commercial banking has been exposed to a special tax, in the form of reserve requirements. It makes no essential difference that the revenues from the tax reach the Treasury via the Federal Reserve. There is no particular reason for this tax, since the Federal Reserve can quite well conduct monetary policy operations without required reserves. The requirement could, then, be phased out to give full effect to the benefits of intermediation.

Most economists regard reserve requirements as secondary to open market operations in conducting monetary policy. The Federal Reserve has made minimal use of changes in reserve requirements in recent years, in part owing to its fear of aggravating the membership attrition problem. Nonetheless, the limited use of this monetary tool has not had a noticeable impact on the ability of the Federal Reserve to conduct monetary policy.

Furthermore, several studies have shown that open market operations have a timely impact on all commercial bank reserves. These studies indicate that the total impact is felt by banks in some regions within the first 2 weeks following open market operations. In most cases, the impact of open market operations on reserves is transmitted within 6 weeks. Moreover, the length of time for the impact of open market operations to be transmitted is not related to the region's distance from money market centers.

What the Federal Reserve does need to conduct monetary policy effectively is information about monetary aggregates. The Reuss amendment to H. R. 12706 would authorize the Federal Reserve, as it deems necessary for the conduct of monetary policy, to obtain from the appropriate Federal agency summary statistics on assets and liabilities of all depository institutions. H. R. 13476 would require depository institutions to report their deposit liabilities and required reserves directly to the Federal Reserve. We support making such information available to the Federal Reserve and have no objection to the adoption of either proposal. We do not believe, however, that adoption of the Monetary Policy Data Improvement Act of 1978 (H. R. 13549) is necessary. This proposal would require the FDIC to collect data on deposit and cash items each week from a sample of 1,000 nonmember banks, including all those having deposits exceeding $100 million, and transmit that information to the Federal Reserve.

Several years ago, the Federal Reserve became concerned about the adequacy of its data on the money supply and established a committee chaired by Professor George L. Bach of Stanford University to recommend changes in money supply statistics. One of the major recommendations of the Bach Committee was that better and more frequent data on nonmember bank deposits were desirable. Following that report, the FDIC instituted a special schedule in the quarterly call report for all ~~weekly survey of a sample of~~ nonmember banks to provide the Federal Reserve with better information on the money supply. The schedule requires nonmember banks to compute a 7-day average of deposits for the 7 days ending with the date of call. This collection was initiated with the spring 1976 Call for Report of Condition.

A second step, also recommended by the Bach Committee, went into effect in the first week of July 1977. A sample of 580 nonmember banks is reporting deposit and cash items on a regular weekly basis, the same items as all nonmember banks report four times a year. The Federal Reserve has indicated that it expects the data from these two surveys to enable significant improvements in their estimates of the nonmember bank component of the Nation's money supply. The FDIC and the Federal Reserve have agreed to review this program in mid-1979 to determine whether nonmember bank data are necessary for monetary policy purposes and, if they are, whether the sample of nonmember banks is adequate. In the interest of improving the timeliness of the survey data to the Federal Reserve, the FDIC intends to request the 580 banks participating in the program to submit the data directly to the Federal Reserve rather than through the FDIC regional offices, which is the present procedure.

In summary, we believe the need of legal reserve requirements for monetary control purposes is not supported by the weight of available evidence. The evidence to date suggests that monetary policy effectiveness depends on adequate data, proper estimation procedures and appropriate open market operations decisions, and not on reserve requirement jurisdiction.

Bank Supervision and the Exercise of Monetary Policy

Representatives of the Federal Reserve System have also argued that significant supervisory and regulatory responsibilities are required for the effective conduct of monetary policy. Chairman Miller reiterated in his testimony before this Committee the Federal Reserve's belief that its activities in the bank supervisory and regulatory area "cannot be readily separated from its job of conducting monetary policy." In the past, representatives of the Federal Reserve have argued as well that an understanding of the nuances of monetary policy and of developments in the economy facilitate bank supervision.

Three major arguments have been advanced by those who believe bank supervision and regulation and the conduct of monetary policy should be separated. First, it has been argued that the Federal Reserve's responsibility for bank supervision diverts attention from monetary policy formation and that this diversion may reduce its effectiveness in implementing monetary policy. Former Federal Reserve Governor James Robertson voiced this concern in stating:

> As a practical matter, I believe it would be seriously detrimental to place in the Board the important additional responsibilities that would accompany unification. There are limits to a man's ability effectively to perform his assigned duties. In our complex society, merely keeping informed of what is going on in the national economy is becoming more and more difficult. Developing and implementing appropriate monetary policy at a given time require consideration and evaluation of the significance of an enormous

> volume of available data and their interrelationships. The responsibilities are of such magnitude that the Board should not be also burdened with the performance of bank supervisory functions. Supervision is too important a function in itself to be the Federal Reserve's part-time job.

This argument has assumed greater importance today than when first made by Governor Robertson because of the Federal Reserve's mushrooming responsibilities under the civil rights and consumer protection laws and because of the ever increasing burdens of holding company supervision and regulation.

Second, some observers find the existing concentration of power within the Federal Reserve System disturbing, given the System's insulation from the political process. They would favor separation of the supervisory and monetary policy functions.

Third, it is argued that when the implementation of monetary policy goals and bank supervision are combined, the former will inevitably take precedence leading to inconsistent and inequitable bank supervision. For example, it is argued that the monetary authority would be loath to restrain the aggressive policies of a group of overextended money center institutions when monetary policy goals are aimed at credit expansion. Conversely, it is argued that the Federal Reserve might move to check bank holding company expansion on safety and soundness grounds when its actual reason is to effect a restrictive monetary policy. Events during the period 1971-1975 are cited to support this proposition. Many, including former FDIC Chairman Frank Wille, believe this combination of supervision and the implementation of monetary policy goals to be inappropriate, arguing that bank supervision and regulation should be based upon an independent appraisal of the condition of the bank and not upon the monetary goals of the moment. Former FDIC Chairman Wille concisely stated the case as follows:

> The basic problem, of course, is that where the implementation of monetary policy goals is combined with bank regulation and supervision, the former will always be viewed as more important than the latter and the temptation or threat is ever present to use the powers of regulation and supervision to reward banks for their cooperation or to penalize banks for their lack of cooperation with the Board's most recent view of its monetary policy goals. Since those goals change with some frequency, the likelihood of a consistent, evenhanded approach to matters of bank regulation and supervision over any length of time is very much in doubt. Whereas prior to 1970, this was a special concern only of large State member banks which the Federal Reserve System actually examined or of member banks forced to the discount window, it is now the concern of every bank in a holding company system.

We believe that the first and third of these arguments have merit. Yet, we think that the merits of the Federal Reserve's contention that it is necessary for it to have supervisory and regulatory responsibilities to conduct monetary policy effectively deserve consideration.

The Federal Reserve has stated two reasons. First, the Board of Governors has contended that information gained directly from examination and supervision of banks provides a useful input in the formulation of monetary policy. This argument implies that supervisory responsibilities provide the Board with a tangible feel for events in the banking system. Former Governor Holland argued in testimony before this Committee that "examiner asset evaluations supply firsthand knowledge of the changing quality of credit.... This provides valuable supplements to the meaning of the quantitative statistics on monetary and credit aggregates."

We do not disagree that information derived from bank examinations and supervision might be helpful to the Federal Reserve. However, the Federal Reserve does not need to be engaged actively in supervision to obtain such information. It could be attained easily through conversations with supervisory agencies or through participation on their boards. Alternatively, the Board could be given authority to collect information reflecting credit quality by means that do not involve the full panoply of supervisory responsibilities. Second, even if monetary policy benefits from information provided firsthand through direct supervision, which cannot be obtained in other ways, one still must consider whether the value of such information outweighs the very substantial costs in terms of time and resources that are consumed by supervisory and regulatory responsibilities. Finally, many analysts question whether such information can possibly be relevant given the lags between changes in credit quality and the examination and between events in the economy and changes in credit quality.

The second reason given for the Federal Reserve's retention of supervisory and regulatory responsibilities is, in effect, that supervisory and regulatory responsibilities and the conduct of monetary policy are mutually reenforcing. Again, testifying before this Committee, then Governor Holland asserted:

> Now more than ever, the Federal Reserve's role as monetary policymaker and as lender of last resort interacts with the effects of prevailing bank supervisory and regulatory policies. Each of these policies increasingly influences the effectiveness of the other. To divorce them is to weaken both.

Governor Holland argued by way of example that if the bank supervisor alters bank capital or liquidity standards "at an inopportune moment, he can dilute or frustrate for a time the thrust of monetary policy."

The difficulty with this position is obvious and it is pointed up in former Chairman Wille's arguments. Sometimes objective supervisory standards will and should run counter to the thrust of monetary policy and will, therefore, dilute or tend to frustrate it. This will be the case whether or not supervision is within or outside of the Federal Reserve System unless the Federal Reserve is really arguing that supervision and regulation ought to be used to facilitate the implementation of monetary policy. This, of course, would be objected to by those who believe in consistent and equitable supervision and regulation and by monetarists who would argue that the attempt to use such a tool is wholly inappropriate and ultimately an ineffective way to conduct monetary policy.

Thus far, we are not persuaded by the case put forward by the Federal Reserve for the importance of bank supervision and regulation to the effective conduct of monetary policy. Furthermore, we believe some benefits will be gained from the functional separation of supervision and monetary policy. Therefore, it is our opinion that the attrition of members from the Federal Reserve System and, hence, a lessening of its supervisory and regulatory presence has not interfered with the effective conduct of monetary policy.

In summary, based on the available evidence and experience, we tentatively conclude that neither control of reserve requirements in nonmember depository institutions nor supervisory jurisdiction is critical to the conduct of monetary policy. In fact, membership might not even be necessary for the Federal Reserve to conduct monetary policy effectively.

II. Dual Banking System

Historically, our Nation's banking system has developed within the unique Federal character of our State and national governments. Today this is manifested in the ability of both the States and the Federal Government to charter banks and other kinds of depository institutions. The vitality of this dualism is maintained by permitting banks to convert from one chartering authority to another.

While some may disagree, we believe the dual system of State and national banks has been a positive element in the American system of government and has contributed to a more innovative and responsive financial system. Accordingly, maintaining a balance between the State and national banking systems is a desirable public policy. The attrition in Federal Reserve membership gives some pause that this balance is more precarious now than it has been in the past. However, despite the decline of Federal Reserve membership, member banks still hold about three-quarters of domestic deposits. Moreover, the largest banks which depend on Federal Reserve clearing and money transfer services represent a hard core of membership and deposits not likely to leave the system.

Nonetheless, we should not maintain a "balance" for the sake of balance. It is clear that Federal Reserve reserve requirements bear heavily on member banks and result generally in such banks carrying more cash than they otherwise would. In direct competition with the nonmember bank, a member bank might be disadvantaged. For example, how can a member bank offer the same rate for a $100 time deposit as a competing nonmember if the member is able to invest less than its competitor because the law requires it to hold more in cash? Its deposit customers will tend to be offered lower rates, its loan customers will tend to be charged higher rates, or its shareholders will receive lower returns.

One solution to the problem of equity that we believe should be resisted is the proposal in H. R. 13476 to impose universal reserve requirements on the transactions balances of nonmember depository institutions. As we explained above, extension of universal reserve requirements to nonmember institutions is not essential to conduct monetary policy effectively. While reserve requirements are primarily responsible for the inequity of Federal Reserve membership, we believe that equity can be achieved in other ways--such as paying interest on reserves, permitting reserves to be held in the form of marketable securities, or reducing reserve requirements--without the necessity of resorting to universal reserves for all institutions.

Universal reserve requirements are perceived as a threat to the integrity of State banking systems. If nonmember banks have to maintain reserves at the Federal Reserve just as member banks must do, but have no access or have limited access to the discount window and other System benefits, why not become members? The assumption is that obligatory universal reserves would not only make nonmembership unattractive, but many institutions would also be inclined to convert to a national charter. The result would be an imbalance in the dual system in favor of membership and the national banking system.

There is little evidence to substantiate the accuracy of such a scenario. The fear may well be a false one. However, the impact of redressing the reserves imbalance on the dual banking system cannot be predicted accurately. It is conceivable that there would be a massive influx into the State member and national systems. If this occurred, many State systems would lose their viability, and the Federal Reserve's and the Comptroller's supervisory authority would have grown substantially without the benefit of Congressional consideration. My point is that the issue of Federal regulatory structure cannot be isolated from this issue of balance. The better of the two proposals--the payment of interest on reserves and lowering of reserve requirements--avoids some serious shortcomings of the universal reserve requirements proposal, but it holds the potential of an inadvertant resolution of an issue which the Congress has conscientiously debated for many years and which deserves conscious choice for its resolution.

III. Banking System Efficiency and Innovativeness

Market pricing of goods and services is vital to the efficient allocation and use of those goods and services. In the words of Milton Friedman, pricing is highly desirable "...to prevent the waste that arises from the absence of specific charges for them." Generally, market pricing encourages competition to improve the quality of goods and services and to lower their cost. Presently, pricing is absent in at least three areas that bear directly or indirectly upon the legislation under consideration: (1) the absence of interest payment on the required reserves of member banks, (2) the provision of services by the Federal Reserve to member banks, and (3) the prohibition of interest payments on demand deposit balances and deposit interest rate ceilings. I will address each in turn.

<u>Interest on Reserves</u>

As a matter of principle, whether to pay interest on reserves should not be an issue. Presently, failure to pay interest is tantamount to the imposition of a tax without calling it that. A substantial amount of the revenue foregone by member banks is passed on to the Treasury Department by the Federal Reserve. Some of the revenue is used by the System to offset the cost of providing "free" services to member banks. If it were the national policy to tax banks, it would be preferable to levy the tax directly on all banks and other depository institutions as well. Then all would be treated equally.

Concern has been raised about the adverse impact payment of interest on reserves would have on Treasury revenues. This concern has lead to attempts to structure a procedure for paying interest while minimizing the loss in Treasury revenues. However, structuring a procedure for paying interest bogs down in questions about the appropriate interest rate, concerns about possible windfall gains to to large banks, and controversy over what percentage of the Federal Reserve System's revenues should be available for interest payments. We submit that none of this is really necessary. It imposes the subjective judgment of men in dealing with the cost of membership when the market system could probably do better. Why not permit member banks to invest their reserves in interest bearing securities? The Federal Reserve could determine what kinds of securities should be eligible for this purpose based on considerations such as risk. This approach would permit each bank to make its own choice and obviate the necessity of having the Federal Reserve establish a rate. Presently, 36 States allow State nonmember banks to hold at least part of their required reserves in the form of U.S. Government securities. To our knowledge, such a change would not have any significant impact on the effective conduct of monetary policy. If either the loss of Treasury revenues or subsidization of small banks were felt to be important problems, we would recommend that the Congress address these problems directly through national tax policy.

To the extent that our faith in the efficacy of the market system might be misplaced, we are willing to endorse the provision in Section 3 of H. R. 12706 (Stanton bill) that would require the Board of Governors to prepare a study on permitting member banks to invest their reserves in securities.

Pricing of Services

Explicitly pricing Federal Reserve services should increase the efficiency of our financial system by allowing various financial institutions to purchase the services they desire from the Federal Reserve or private alternatives. Among the Federal Reserve System's major services are: operation of the payments system, including check processing and transportation and automated clearinghouse services; pickup and delivery of coin and currency; wire transfers; purchase, sale, safekeeping and clearing securities; and operation of the discount window.

The Federal Reserve has proposed pricing most of these services except the discount window in a two-phase process. In the first phase, pricing of services would be limited to those connected with the payments mechanism and access would be limited to member banks. This would permit the Federal Reserve time to develop appropriate prices before bringing in all depository institutions. Services would be priced according to geographic region and whether the activity in question is processed through a city bank, country bank, regional check processing center, or interdistrict transfer. Nonmember institutions would be permitted to deposit intraregional checks and drafts through regional check processing centers. In the second phase, nonmembers could purchase virtually all services the Federal Reserve has to offer, but would continue to clear checks and drafts through reserve accounts of member banks. Charges for services would not be determined on the basis of membership.

The Stanton bill would require the Federal Reserve to price each service explicitly, based on all the costs of providing the service including overhead plus a return on capital. The Federal Reserve would be required to offer each service to every depository institution at the same fee.

If interest were paid on member bank reserves, by whatever means, pricing of Federal Reserve services would be essential to prevent discriminatory treatment of nonmember depository institutions. Pricing of services also is sound policy because it would enhance the efficiency of the financial system. This would provide a better opportunity for the correspondent banking system to compete with the Federal Reserve. Such competition, in turn, should encourage the Federal Reserve to eliminate waste, to improve services and to offer new ones.

The Federal Reserve has stated its opposition to the Stanton bill which would require the System to price each service on the basis of costs and a return on capital. Governor Coldwell pointed out that private competitors would not be required to price services separately as the Stanton bill would require of the System. This loss of flexibility would place the System at a significant competitive disadvantage. It should be noted, however, that if the Federal Reserve is not subject to pricing guidelines of some sort, it could achieve the same advantage that the Stanton bill would provide to private competitors. Assuming that it is good public policy to maintain a significant presence for the Federal Reserve in the payments mechanism, we are sympathetic to its concern about constraints on its flexibility in setting prices. Therefore, we would recommend that the matter of pricing guidelines receive careful study prior to the enactment of legislation on the issue of pricing. Some of the reasons for favoring such an intermediate approach and some of the matters that need to be considered are discussed below.

The costs of producing the same service for a variety of customers may differ in various areas of the country because labor and capital costs are not equal. Thus, it may be more efficient to allow the Federal Reserve to charge different prices according to the costs of providing services to different customers. The cost of providing a certain service to nonmember banks and nonbank depository institutions could be below the cost of providing the same service only to member banks. This could result from the way in which a service were utilized. For example, a credit union may not require daily pickup and delivery of coins or currency, or a savings and loan association might not complete security transactions as often as a commercial bank.

To allow the Federal Reserve some flexibility in developing and implementing a pricing system, the Federal Reserve could be permitted to price services explicitly by broad service classes. One price schedule might be developed for payments services, another for securities services, and another for transportation. Perhaps a cost-plus pricing system could be developed for the services now provided by the Federal Reserve, and the markup over the cost of providing the service might be limited to a fixed percentage.

There seem to be economies of scale associated with at least some services that the Federal Reserve now provides. If these economies are pervasive, the Federal Reserve will be able to offer the relevant service at a lower price than any private competitor. There is nothing undesirable about this, but the result should be determined by experience, not fiat. It is not unlikely that the Federal Reserve has a natural monopoly on some services because private competitors could not attract sufficient volume to offer the same services at as low a price.

According to materials that former Federal Reserve Chairman Burns submitted to Senator Proxmire on October 4, 1977, in recent years the per unit costs of conventional check processing, return items, transfer of funds, and automated clearinghouse activities have declined as volumes increased. If these trends continue, the private sector might not be able to offer competing services at costs that are as low as those incurred by the Federal Reserve. On the other hand, the cash services offered by the Federal Reserve do not seem to show declining costs with increasing volumes. In an electronic banking environment, it is not clear that several payments systems can compete efficiently. However, in this regard the private bank wire continues to compete with the Federal Reserve wire, and networks of correspondent banks provide payment services that are preferred by some member banks over Federal Reserve payment services.

Interest on Demand Deposits

Payment of interest on reserves of member banks potentially could place nonmember banks at a disadvantage because the 40-year old prohibition against the payment of interest on demand deposits does not permit member banks to pay interest on correspondent balances. These balances often serve as reserves for nonmember banks and serve as well for check clearing operations and compensation for other correspondent services. If the principle of explicit pricing is adopted for member banks, then parallel treatment would dictate that banks should have the choice of paying interest on correspondent balances and levying explicit charges for correspondent services. There can be little doubt that this would increase the efficiency of the financial system.

As a matter of principle, if the interest prohibition is lifted for correspondent deposits, it should be lifted for all demand deposits. I have long supported elimination of the prohibition of interest payments on all transactions balances as well as removal of interest rate ceilings on other kinds of deposits. Economists have demonstrated that there is no merit to the contention that competition for demand deposits through the payment of interest led to bank failures during the Depression as some contend. They have also demonstrated, at least to our satisfaction, that competition for deposits through the pricing mechanism would result in a more efficient allocation of resources than competition through indirect means involving the implicit payment of interest by building more branches, keeping open longer hours, providing free checking services, offering premiums and free travelers' checks, as well as a variety of other services. Such competition would lead to substantial benefits for both financial institutions and bank customers.

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Under the present system of implicit interest payments on checking accounts, depositors are denied the opportunity to determine for themselves how they wish to spend their portion of the income the bank earns on their deposits. If interest were paid, a depositor might choose to consume the same services that banks now offer in the course of competing with other institutions for accounts or a depositor might choose to forego such services and spend interest income on different goods and services. This is an important benefit--consumers would decide how to spend their interest income, not the banks.

Free- or below-actual-cost checking encourages inefficient use of resources because depositors have little or no incentive to economize on check writing, even though check clearance costs are substantial. Direct charges for checks are likely to prompt depositors to write fewer checks. Such fees should cover a substantial cost of clearing checks. Management's adoption of pricing policies more nearly in line with the costs of providing services to customers will enhance a financial institution's capability of paying a competitive interest rate on deposit balances without impairing earnings.

Payment of competitive interest rates will lower some operating costs by reducing the need for customers to transfer funds from non-interest bearing checking accounts to savings accounts. Thus depositors will no longer find it necessary to maintain separate checking and savings accounts. Customers will not need to spend as much time and effort in managing deposit balances, particularly when interest rates are high. Also, existing inequities, whereby some depositors pay less than the cost of servicing their accounts will be eliminated.

IV. Banking System Viability and Liquidity Pressures

One of the important functions of the Federal Reserve System is to serve as the Nation's lender of last resort. Through the vehicle of the discount window, the Federal Reserve is able to provide liquidity when it is needed. The discount window acts as a safety valve by permitting the Federal Reserve to cushion the impact of a tight monetary policy on individual institutions. It can also assist member banks in meeting routine but unexpected loan demand or deposit withdrawals, seasonal liquidity requirements, and emergency liquidity needs. A member bank's first recourse is expected to be to the market. If sufficient funds are not available in the market, the Reserve Bank might provide accommodation, but it is understood that it is temporary. Each member bank must eliminate its discount window borrowings within a reasonable period. Reserve Banks also require member banks to pledge collateral, typically of high quality.

The Federal Reserve Act authorizes entities other than member banks to use the discount window only under "unusual and exigent" circumstances. As a result, the Federal Reserve indicates, for example, that no nonmember bank has borrowed from the discount window since 1966.

While nonmember banks also face unexpected needs for liquidity, they ordinarily cope with them with little difficulty by borrowing from correspondent banks in much the same way that members do from the Federal Reserve. Indeed, even when nonmember banks are in trouble, it is generally possible for them to borrow from correspondents if they have sufficient and acceptable collateral. To be sure, the lending bank may also impose special conditions on the borrowing bank. But in that regard, the Federal Reserve also behaves like a careful creditor in accommodating a floundering bank. It makes sure such loans are well collaterized, that its interest in the collateral is perfected, and that the borrowing bank is solvent. Thus, the fact that nonmembers do not have window accommodation is not seriously disadvantageous in most circumstances.

The Federal Reserve believes that the ability of the financial system to handle liquidity "crunches" will weaken if membership attrition continues unabated. It should be understood that the decline in Federal Reserve membership does not impair the ability of the System to cope with the kind of generalized liquidity crisis most of us are concerned about, in which the public demands more cash than the banking system holds. Aggressive open market operations and discount window accommodation to members can provide cash sufficient to meet the public's demand. The decline in membership does impair the ability of the system to minister to a localized liquidity squeeze involving one or a few institutions. In the past, the Federal Reserve has sometimes resorted to conduit loans in such circumstances--that is, loans to a member bank which in turn provide credit to a nonmember institution. We think that the Federal Reserve should accommodate a nonmember bank directly in such special circumstances.

Indeed, we are concerned that membership attrition has contributed to a narrow interpretation of the words "unusual and exigent" by the Federal Reserve. If experience is a guide, these words appear to be interpreted by the Board of Governors as requiring a national emergency before a Reserve Bank would be authorized to lend to a nonmember institution. The interpretation could be less restrictive, but at the present time it does not appear that the Board of Governors is willing to interpret "unusual and Exigent" circumstance as extending to situations that are unique to an inidividual nonmember institution. The unwillingness of the Federal Reserve to open the discount window to American Bank and Trust of Orangeburg, South Carolina, in September 1974 led the FDIC to take the unusual step of providing short-term liquidity directly to the bank under Section 13(c) of the FDI Act. This was the only time the FDIC ever took such action for temporary liquidity purposes.*

Former FDIC Chairman Frank Wille in a letter to Mr. St Germain in January 1975 stated:

> I believe that the statutory provisions, regulations and policies surrounding direct Federal Reserve loans to nonmember banks need to be reviewed and a procedure adopted whereby the failure of a nonmember bank will not be precipitated by a sudden and purely temporary need for liquidity.

We share Chairman Wille's concern. We believe that emergency borrowings from the Federal Reserve discount window should be available to member and nonmember banks alike upon certification by the FDIC that they are in danger of failing and that such assistance is necessary for a temporary period until a merger, a receivership sale or some other orderly resolution of the bank's problems is arranged. The FDIC, in turn, should be authorized to guarantee the repayment of such borrowings out of the resources of the deposit insurance fund. In connection with this authority, the FDIC should be required by law to keep the Federal Reserve fully informed with up-to-date information as to the financial condition of all banks certified to borrow from the discount window under this provision.

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*Two weeks later the bank was closed.

Mr. MITCHELL. Thank you very much.

I think it would be best if we heard from the rest of the witnesses so that we can question them all at the same time.

Thank you very much for your testimony.

Mr. Wicks.

STATEMENT OF PARKE W. WICKS, PRESIDENT AND CHIEF EXECUTIVE OFFICER, FIRST TRUST & DEPOSIT CO., SYRACUSE, N.Y.

Mr. WICKS. I appreciate the fine introduction I received from my good friend, Congressman Hanley.

I am Parke W. Wicks, president and chief executive officer of First Trust & Deposit Co. of Syracuse, N.Y. We welcome the opportunity to meet with you and to share our views on the Federal Reserve membership issue.

By way of background, First Trust & Deposit Co. is a $500-million-asset commercial bank serving a five-county central New York marketing area of approximately 1 million people. We operate a network of 43 branch locations and 50 point-of-sale electronic fund transfer terminals.

We are a subsidiary of First Commercial Banks, Inc., an upstate New York holding company comprised of six commercial banks covering 23 counties, and with assets of $1.9 billion. I am pleased to be serving, as well, as a director of this organization.

First Trust's local roots go back well over a century. Today we are a strong community bank with more than 56 percent of our business mix going into the consumer segment. Of our $80 million mortgage portfolio, 99 percent goes to work right in New York State. This is despite the fact that New York is the only State in the Union which limits its return to 8.5 percent on residential mortgages.

This past January the board of directors of our bank voted to withdraw from the Federal Reserve System. This action was taken concurrently with two of our affiliate banks, Kingston Trust Co. and Oystermen's Bank & Trust Co.

On Wednesday, August 2, we effected withdrawal. This was not an easy decision. Our relationship with the Fed goes back to December 24, 1913, when we applied to join the newly formed Federal Reserve System as a charter member. Over the years a most pleasant and professional working relationship developed mutually.

But, during this 65-year period the overall banking climate has changed. In recognition of these changes, we undertook a complete review of the potential benefits of withdrawal in 1973. While identifying the possible monetary advantages, we concluded that congressional action to correct the developing inequities of Fed membership was imminent. Consequently, we decided to withhold action.

Here we are 5 years later and what has happened?

Continued inflation and high money rates make the opportunity cost of Fed membership greater than ever.

There are other factors: The NOW experiment in New England; third party payment powers by thrift institutions in New York and other States; automatic transfer powers with resultant interest on transaction accounts; the continuing question of interest parity and its impact on our market base; and the prospect of interest on Treasury tax and loan deposits.

These all serve to deplete our profit markings at a time when bank capital ratios are at their lowest levels since the depression.

In my capacity as a director of a bank holding company, capital formation in today's marketplace has to be our prime concern. In executing our responsibility to our shareholders and our depositors, we must look not only to ways to increase the profits of the bank and therefore improve our rate of internal capital generation, but also to make our stock more attractive to the investor. In this way we can continue to be innovative in our products and to meet the needs of the communities we serve.

Withdrawal from the Fed offers us the opportunity to do just this. As an illustration, I will use our 1977 average balance sheet figures.

During the year we had an average of $396 million in deposits. Against this total we were required to maintain $23 million in sterile reserve assets which includes cash on hand and balances with Fed. This is approximately 6 percent of our deposits.

Because of the difference in reserve requirements, and by definition those assets which qualify as reserve for a State nonmember bank, we are able to free-up for our use approximately $11 million. This is in line with a study published by the Federal Reserve Bank of St. Louis in March 1978, entitled "Federal Reserve Requirements and Their Enforcement: A Comparison Across States."

In reference to the services hitherto performed by the Fed, we are able to obtain these services from our correspondent banks for approximately $1.5 million compensating balances, which perform double duty as part of our reserve base. This includes substantial lines of credit to replace lost Fed window borrowing privileges. At current money market rates, we are estimating the net after-tax impact upon First Trust at $380,000 on an annual basis. This equates to a 10-percent increase in our return on assets.

In your deliberations, I request you give serious consideration to the cost to member banks of the sterile balances maintained at the Fed, and its detrimental effect on both the Fed membership question and banking practices in general.

I believe Congress should also consider the issue of reserve inequities, especially as they exist between the commercial banks and thrift institutions which have the advantages of third party payment accounts combined with the interest differential. I am convinced that unless these inequities are resolved, the attention in Fed membership will continue at an accelerated rate.

Ultimately any solution must incorporate, in my opinion, a reasonable rate of return on reserves based on prevailing market conditions, an equitable distribution of reserve requirements and a competitive fee structure for services performed. I firmly believe that, to be effective, any legislation must look beyond the short-term impact on the Treasury.

Mr. MITCHELL. We thank you for your presentation and for accommodating the committee by being here this morning.

Mr. Leonard?

STATEMENT OF HARRY E. LEONARD, BANK COMMISSIONER, STATE OF OKLAHOMA, PRESIDENT-ELECT, CONFERENCE OF STATE BANK SUPERVISORS, ON BEHALF OF THE CONFERENCE; ACCOMPANIED BY DR. LAWRENCE E. KREIDER, EXECUTIVE VICE PRESIDENT-ECONOMIST, CONFERENCE OF STATE BANK SUPERVISORS

Mr. LEONARD. Mr. Chairman, my name is Harry E. Leonard. I am bank commissioner for the State of Oklahoma and president-elect of the Conference of State Bank Supervisors—CSBS—on whose behalf I am testifying today.

With me is Dr. Lawrence E. Kreider, executive vice president-economist of the conference.

CSBS is the nationwide organization of State officials who constitute the primary chartering, examination and regulatory source of 10,550 State-chartered commercial plus mutual savings banks with total assets of $670 billion.

CSBS is particularly appreciative of the opportunity to testify on H.R. 12706, the "Federal Reserve Membership Act of 1978" and related proposals.

The House Committee on Banking, Finance and Urban Affairs is to be commended for its approach to the request for these hearings. Your insights, Mr. Chairman, on the tools the Fed needs—and doesn't need—to discharge its monetary policy responsibilities are most encouraging to observe. The conference agrees with a number of comments expressed by the chairman and reported in the Congressional Record of Friday, July 14, 1978, particularly with reference to the Fed not needing universal reserve-setting authority for its monetary policy role.

The conference wishes to emphasize that our comments today are intended to be supportive of what appears to be the committee's basic goals in these hearings. We do, however, wish to offer for your consideration some concepts which might be developed as alternative approaches toward objectives we share in common.

Our emphasis will be on H.R. 12706, as amended, since the chairman has recommended that it be the primary legislative vehicle at these hearings and since it has a more meritorious foundation than related proposals under consideration.

First, however, it should be recognized by all—as the chairman of this committee implied in statements on the floor of the House—that the so-called "Federal Reserve membership problem" is of a somewhat different nature than some have claimed.

To our knowledge, for example, it has not been demonstrated that the decline in Fed membership was a significant causal factor in faulty monetary policies during much of the period from 1965 to 1975.

Indeed, there is a widely held contrary belief by monetary observers from outside the Federal Reserve System and by some from within.

Declining Federal Reserve membership, if it is a problem, is primarily of a practical political constituency nature. It goes to the question of how much unbridled power an independent public agency should have.

Further, to the extent it reflects inequitable treatment of some member banks, the Fed unilaterally or with readily acceptable statutory changes could have largely or entirely solved the problem long ago.

On the other side of the issue, it has been observed that withdrawals to date from the Fed have strengthened the ability of the private correspondent banking system to serve the thousands of communities of our Nation.

Second, if it is feared that further withdrawals might at some future date create monetary problems—even though such fears are not justified by available evidence—it must be recognized that there is a floor below which membership will not fall. That floor is established by the fact that the majority of member bank assets are now in banks that enjoy net benefits from membership. As you know, membership normally is one requisite to a dynamic correspondent banking operation by individual banks.

A summary of related data illustrates this point. At the beginning of this year, 74 percent of all insured commercial bank deposits were in member banks. Approximately two-thirds of these deposits were in banks with $5 million or more of correspondent "due to" balances, and a large proportion of the banks holding significant amounts of correspondent deposit liabilities will remain as a Fed membership base. There is a strong relationship between Fed membership and correspondent banking services as evidenced by the fact that 95 percent of the aggregate deposits of correspondent-type banks are in members banks as compared with the figure of 74 percent noted earlier for all insured commercial banks, including noncorrespondent types.

Further, observations of banks which have withdrawn from the Fed reveal that very few of them are heavily involved in correspondent banking. Those that are heavily involved tend to stay in the System.

In addition to this strong correspondent bank Fed membership base, numerous other banks will remain as members for a variety of reasons. The chairman of this committee appropriately recognized this strong base of continuing membership when he referred on the floor of the House on July 14 to "the many banks which have no intention of leaving the Federal Reserve System."

Further, each withdrawal makes it more attractive for remaining member banks to stay with the Fed because each withdrawal tends to transfer balances from the Fed to private correspondent banks. This increases the total "pie" of correspondent balances for which correspondent bankers who are members of the Fed can then compete.

Thus, if some level of membership is significant from monetary policy or public interest standpoints, and we doubt that it is, there is a floor which will assure that a majority of commercial bank deposits remain in "Fed constituent" banks.

Third, inequities which may now exist between member/nonmember bank groups and between members could largely be eliminated by relatively moderate adjustments in Fed reserve requirements. A reduction of 1 percentage point, for example, in reserve requirements for certain member banks would largely solve the equitable treatment problem. I will comment in more detail on that point later.

In view of the facts that declining Fed membership has not contributed significantly to monetary policy imperfections, a floor limiting withdrawals exists, and any inequities between banks that may be attributable to Fed reserve requirements largely could be eliminated by relatively moderate adjustments in reserve requirements, the conference believes that the much publicized Fed membership problem is of a different nature and less serious from the monetary policy and public interest standpoints than claimed by some Fed officials.

If, however, the committee is of the judgment that action must be taken for Fed "constituency" or whatever reasons, to limit withdrawals from the Fed, the conference respectfully suggests a congressional program which would have the following benefits: Minimize the net impact on the Federal budget; encourage most member banks to remain in the Fed; reduce the reserve burden on all member banks; permit the private correspondent banking system to compete more effectively for correspondent business; cause a minimum of disruption of desirable interbank relationships and bank services; achieve more equitable treatment between correspondent and noncorrespondent types of banks; and be relatively simple to implement and be effective.

These goals can be accomplished by one or more of the following alternatives:

First, consistent with a basic concept introduced in H.R. 12706 as amended, set reserves on the first $10 million of the total amount of demand deposits and transaction accounts of any member bank at a reduced level of 4 percent. All member banks would get some relief. Smaller member banks, however, would get proportionately more relief from reserve burdens than would larger banks.

This alternative would impose a smaller net burden on the Federal budget than H.R. 12706, as amended, and far less than the burden which would be imposed by Fed proposals, yet it would achieve goals sought by H.R. 12706, as amended.

Further, this proposal would reduce the possibility of a "reserve war" between the States and the Fed which might ensue if reserves were removed completely on the first $10 million of member bank deposits.

Second, reduce reserve requirements by 1 or 2 percentage points below present schedules for member banks not heavily involved in correspondent banking. The criterion for "heavily involved" could be set using a ratio of correspondent balance liabilities to total deposits. A ratio of 0.02 to 0.03 would be a reasonable division between "heavily involved" and "not heavily involved."

As a specific example, a member bank with net demand deposits of $8 million, time deposits of $8 million, total deposits of $16 million, and correspondent demand balance liabilities less than $320,000, would have reserves reduced by 1 percentage point on each of its deposit categories or by 2 percentage points on demand deposits. A gradual reserve requirement transition between the two ratios of 0.02 to 0.03 could be established.

This proposal would free less reserves than the first alternative above, H.R. 12706, as amended, and Fed proposals; would therefore minimize the drain on the Federal budget and would reduce the reserve burden most selectively and accurately for those member banks which may presently be tempted to withdraw from the Fed. This proposal most closely represents a "rifleshot" solution to the problem. It suffers, however, from the fact that it would inject into the reserve determination process a criterion other than deposits and would also add arithmetic complications to the reserve schedule.

Third, set reserves on all member bank net demand deposits at 1 percentage point below the present schedule. This would free approximately $1.8 billion of reserves. It would, however, reduce reserves for banks not likely to withdraw just as it would those seriously considering withdrawal.

From an ideal conceptual standpoint, the second alternative above is advantageous. It would go sharply to the problem. From a practical standpoint, however, the first alternative may be preferred since it would be less complicated, yet would largely achieve goals stated by the chairman of this committee, and achieve benefits listed above.

The third alternative has the advantage of simplicity. It has serious disadvantages, however, in that it would be more costly to the Federal budget and would tend to create inequitable treatment between classes of member banks and between member and nonmember banks.

The conference would like to recommend that the committtee give serious consideration to alternative No. 1 above, which is a modification of H.R. 12706 as amended.

These proposals do not include compulsory affiliation of nonmember banks or other depository institutions with the Fed for reserve purposes. The conference wishes to support the Chairman's statements on the floor of the House on July 14 to the effect that universal reserve requirements are not necessary for improved monetary control, would unnecessarily impose burdens on certain banks and would extend the regulatory jurisdiction of the Fed beyond present limits thus upsetting the long-established regulatory jurisdictions of State banking departments and others.

CSBS has testified on previous occasions in support of continued optional affiliation with the Fed for reserve purposes, has documented this support with an in-depth study entitled "Optional Affiliation with the Federal Reserve System for Reserve Purposes Is Consistent With Effective Monetary Policies," and knows of no showing by the Fed to document its contention that compulsory affiliation is necessary for effective monetary policy.

The proposal for compulsory affiliation for reserve purposes is without redeeming merit from a national interest standpoint. Congress very wisely has consistently rejected such a proposal, and it should forever be discarded.

Further, the proposals outlined above by CSBS do not explicitly include the collection of additional data which may be needed for the conduct of monetary policy. CSBS, however, favors the ready availability to the Fed of statistical or other data for monetary policy purposes whenever there is a demonstrated need, and it has cooperated with the Fed and others whenever a need has been shown to exist.

Each request for data, however, should stand the test of cost/benefit analysis. The Fed should not have the unrestrained right to any and all data it might request, or in the form it might request it. Experience suggests that such authority could likely violate cost/benefit principles. CSBS agrees with the Chairman's reported view that such data should be collected through established sources, including the

FDIC and State banking departments for State-chartered nonmember banks.

CSBS at this time is not prepared to comment officially on the issue of pegging the discount rate to a money market rate; nor on the complex question of payment of interest on reserves up to an aggregate amount received by the Fed from explicit charges for services; or on the question of who should set reserve requirements.

These are certainly valid questions for this committee to raise. As the specifics of these proposals and their impact on CSBS goals of strong State banking departments and effective State/Federal checks and balances become more clear, we would ask if we might be permitted to submit a supplementary statement to the committee.

Mr. Chairman, thank you for the opportunity to testify on important issues which are being pursued in depth by your committee.

Mr. MITCHELL. We thank you for your very provocative testimony. Certainly we would welcome the submission of a supplementary statement.

Mr. LEONARD. Thank you.

Mr. MITCHELL. Mr. Perkins?

STATEMENT OF JOHN H. PERKINS, PRESIDENT, CONTINENTAL ILLINOIS NATIONAL BANK & TRUST CO., CHICAGO, ILL., PRESIDENT-ELECT, AMERICAN BANKERS ASSOCIATION, ON BEHALF OF THE ASSOCIATION; ACCOMPANIED BY LEIF OLSEN, CHIEF, ECONOMIC POLICY COMMITTEE OF CITIBANK, NEW YORK, N.Y., AND CHAIRMAN, ECONOMIC ADVISORY COMMITTEE, AMERICAN BANKERS ASSOCIATION

Mr. PERKINS. Mr. Chairman and members of the committee, I am John H. Perkins, president of the Continental Illinois National Bank & Trust Co. of Chicago, Ill.

I would like to ask that my prepared statement be incorporated in the record at this time and I will summarize it.

Mr. MITCHELL. Without objection, that will be done.

Mr. PERKINS. I am also president-elect of the American Bankers Association, a trade association whose membership includes more than 92 percent of the Nation's 14,383 full-service banks.

Accompanying me is Leif Olsen, chairman of the economic policy committee, Citibank, New York, N.Y., and chairman of the economic advisory committee of our association.

We are delighted to be here today to testify on the important proposals before your committee. There are few absolute certainties in any of the arguments pro and con to the proposals for change. All of us are having to speculate about living in a Federal Reserve operating environment none have experienced.

The first question for consideration should not be, how do we maintain a relatively high level of membership in the Federal Reserve System? Rather, more fundamental objectives should be clearly stated. Our association believes these objectives are paramount: to assure the continued independence and effectiveness of our central bank in its management of monetary policy; to enhance the efficiency of the payments system; and to eliminate arbitrary forms of discrimination against particular types of financial institutions which inhibit the delivery of banking services at least possible cost.

The proposals before you, H.R. 13476, the Reserve Requirements Act of 1978, and H.R. 13477, the Interest on Reserves Act of 1978, and H.R. 12706, the Federal Reserve Membership Act of 1978, are constructive attempts to deal with the first two concerns, although we do have some specific disagreements with them. Our third concern is barely addressed in the proposals. There appears, in fact, to be an attempt to justify discrimination against medium-sized and larger banks on the grounds that they are not leaving the Federal Reserve as frequently as smaller banks and hence do not deserve the same level of relief from the excessive burdens of membership. There also appears to be a belief that such discrimination will mitigate Treasury revenue losses. The first notion is simply unfair and, as we shall discuss below, the second is probably incorrect.

In discussing legislative and regulatory proposals, the policymaking bodies of the American Bankers Association attempt to discipline their thinking by asking four questions: How do bank customers benefit from the proposal? Will the proposal enhance the broad competitive environment? Is the proposal consistent with national economic and social priorities? Does the proposal achieve or maintain equal competitive ground rules among various types of competing financial institutions, and does it provide opportunity for competitive financial institutions to maintain viability and profitability regardless of size?

An attachment to this testimony analyzes the proposals before you in terms of these criteria.

We have been involved in research and discussion of the issues raised in these legislative proposals for some time. Attached to our testimony are other documents which might prove useful to the committee and we request that they be made a part of the record of these hearings.

First: ABA testimony before the Subcommittee on Financial Institutions of the Senate Committee on Banking, Housing and Urban Affairs, on June 21, 1977. This testimony discusses NOW accounts, the Federal Reserve's membership problem, and S. 1668, our association's legislative proposal to deal with these issues.

Second: ABA testimony before the Senate Committee on Banking, Housing and Urban Affairs, on October 11, 1977, on the role of the Federal Reserve in providing payments services.

Third: A letter from ABA to Senator Richard Lugar dated November 4, 1977, discussing the extent to which required reserves might be reduced for Federal Reserve member banks without impairing the effectiveness of monetary policy.

Fourth: An outline of a research project the ABA will undertake to determine the impact of pricing of Federal Reserve services and relief of the Federal Reserve's membership problem on the structure of the banking industry. This outline was part of a request for proposals that was sent to various consulting firms. We are currently in the process of evaluating their proposals and hope to begin the project soon.

THE CENTRAL BANK AND ITS MANAGEMENT OF MONETARY POLICY

The need for mandatory universal reserve requirements on transaction accounts held by all depository institutions in order to assure an effective monetary policy has not been demonstrated. We oppose this proposal as unjustified and likely to harm our Nation's innovative system of dual banking.

The Fed has sponsored this proposal as a means of increasing the effectiveness of its monetary management. Nevertheless, it should be noted that the Federal Reserve does not have universal support for its view that reserve requirements are a necessary tool for monetary policy. It is our view that reserve requirements for existing Fed member banks could be significantly lowered, and the membership burden concomitantly relieved, without any significant diminution of the Fed's ability to conduct monetary policy. To achieve this within a framework in which the Fed retains maximum flexibility to use reserve requirements for monetary policy purposes, we propose that existing statutory minimum reserve requirements be eliminated. Our views on this point are amplified in the attached letter to Senator Lugar.

It is true that the percentage of transaction accounts subject to reserve requirements of the Federal Reserve is declining. The decline of Federal Reserve membership is only one factor accounting for this. Another is the increasing proportion of transaction accounts that are held outside the banking industry. Differing levels of reserve requirements among member and nonmember institutions can cause additional instability in the money supply as deposit shares of these different categories of institutions change and money flows among them. But economists in the banking industry believe that a much greater source of instability is the graduated levels of reserve requirements among banks who are already members of the Fed. Elimination of these differences would be a significantly greater contribution to monetary stability—and an act of simple fairness to the institutions involved.

We disagree with the proposal that would legislate inflexible reserve requirements because this would tie the hands of the Fed in its ability to use changes in reserve requirements as a tool of monetary policy. We believe, however, that existing reserve requirements levels can be reduced, and favor giving the Fed the ability to do so to the extent that it prudently can. An appropriate move for the Congress would be to set the minimum of the statutory ranges at zero, rather than setting the exact levels by legislative action.

As already stated, we believe that probably the reduction in reserve requirements should be the preferred method used to alleviate the current membership burden. However, if it is administered fairly, we do support proposals calling for the payment of interest on reserves. Indeed, the two methods can be considered complementary to each other.

Limiting the payment of interest on reserves to revenues received from the pricing of services as specified in the proposed amendment to H.R. 12706, would, however, aggravate rather than alleviate, the Fed's membership problem. This would occur because H.R. 12706 also provides for equal access for all institutions to Fed services. As Chairman Miller has already testified in these hearings, the revenue received from the pricing of services would be insufficient to effectively eliminate the membership burden. Hence, since access is available to everyone, the membership drain would be accelerated. The Fed could try to combat this by raising its prices in hopes of increasing the revenue it has available to pay interest. But if its customers were price sensitive and looked for other providers of payments services, this probably would not work.

The gathering of additional information from nonmember institutions provided the data are needed for monetary policy purposes and the data gathering is done in a way that minimizes the reporting burden placed on those institutions has our support.

We do not support tying the level of the discount rate to the Treasury bill rate because this would also tie the hands of the Federal Reserve in the use of this tool for monetary policy purposes. Changes in the discount rate are widely understood in financial markets both at home and abroad. They can be used to lead market interest rates down at the start of a recession. The use of a signal by raising the rate during a recent period of disorderly foreign exchange markets was a key in limiting serious market problems. We understand the concern supporters of this provision have over "arbitrage profits." Indeed, it is quite natural for bankers to pay attention to interest rate spreads between the funds they receive and the funds they lend. This is the heart of their business. Nevertheless, in addition to power to set the discount rate, the Fed has administrative controls on the use of the discount window which we believe are sufficient and appropriate. Also, the total earnings of the Federal Reserve from the use of the discount window are only $40 million. We believe the bulk of this represents earnings on legitimate loans. The earnings of the banking industry are approximately $8.9 billion and those of the Federal Reserve System are approaching $6 billion. Surely any unnecessary "arbitrage" profits are very small relative to the earnings of the banking industry and the Fed. It seems more prudent to let the Fed retain flexibility in the use of this tool.

While we do not agree with all of the specifics of the various proposals to solve the Fed's membership problem, we continue to believe that, for the foreseeable future, a strong membership base will be very important to the conduct of monetary policy. The problem is urgent and attention should be paid to it as soon as possible. We are acutely aware that the cost of Federal Reserve membership is an important item on the current agenda of bank board meetings all across the country. As Chairman Miller pointed out in testimony before this committee in these hearings, and as Secretary Blumenthal pointed out in hearings last year on S. 1664 and S. 1668 which dealt with the membership problem, the longer the problem continues, the more banks will withdraw from the System and Treasury revenues from that source will decline anyway. Limiting the options available to relieve the membership burden because of concern over current Treasury revenues could be penny-wise and pound-foolish. By the Federal Reserve's own estimate, withdrawals from the Fed since 1970 reduced Federal Reserve payments to the Treasury in 1977 by nearly $200 million from what they otherwise would have been. The problem is long run. It is structural. It is continuing, and it should be solved.

ENHANCEMENT OF THE EFFICIENCY OF THE PAYMENTS SYSTEM

We believe the efficiency of the payments system would be greatly enhanced if the Federal Reserve charged for its services. However, we must note that we foresee several difficulties in pricing of existing Federal Reserve services and the provision of new ones. The problem of determining proper cost allocations is difficult enough for private firms. If the Fed decides to take into account its own costs in setting its prices, as it most certainly should, the situation is substantially more difficult. How does one allocate overhead costs among such diverse activities as the administration of monetary policy through open market operations, the provision of services as fiscal agent for the Federal Government, the supervision of State-chartered member banks, the regulation of bank holding company activities, and the provision of payments services which also can be provided by private banks? Even if all the relevant data were known, we can think of no way to do this on a rational basis. Indeed, as new payments systems evolve, it becomes more and more difficult to even know the relevant data.

The provision of payments services is the main banking area in which the Fed competes directly with the private banking system. Yet with 12 regional banks, each having several branches which serve primarily as operations centers, the Fed already has a nationwide system of operations centers in place. There is no way a single bank can match this capability under the current banking structure. This makes accurate comparisons of the public and private clearing systems more tenuous.

The proposal to limit payment of interest on reserves to revenue received from pricing would diminish rather than enhance the efficiency of the payments system. We have already discussed why it would accelerate the membership drain. This accelerated loss of membership might cause the Fed to become more aggressive in providing new services in an attempt to raise pricing revenue so as to be able to alleviate more of the membership burden. If it believed its customers were price-elastic it could, to the extent Congress and its auditors permit it, undercut the private sector in an attempt to raise its revenues in order to pay more interest on reserves and achieve a greater alleviation of its membership burden. Neither of these responses would enhance the efficiency of the payments system, and it is not clear that either of them could ever enable the Fed to achieve an effective elimination of its membership burden.

We are somewhat dismayed by the Federal Reserve's comment that if universal reserve requirements were enacted the Board would have to reevaluate its program to reduce the cost burden of required reserves and price its services. We believe the Fed should reduce the cost burden of reserves and price its services regardless of the structure of reserve requirements among depository institutions. Such a program, if properly constructed, would greatly enhance the efficiency of the payments system without significantly diminishing its ability to conduct monetary policy.

It is our strong belief that an efficient payments system will be maintained only if there is a strong, healthy, private-sector alternative to payments services provided by the Fed. To insure this, we would propose two rules to which the Federal Reserve should be bound in setting its prices: First, Fed prices should not be less than fully allocated costs, including allowances for overhead, cost of capital and taxes.

The cost of float is an important part of these costs; and second, Fed prices should not be less than what the private sector would charge for similar services.

Although these standards would be difficult to enforce, they are not mutually exclusive, and both should be used in the evaluation of Fed prices. If this is done in a fair and impartial manner, the efficiency of the payments system will be greatly enhanced. Our testimony before the Senate Banking Committee on October 11, 1977, which follows my prepared statement, elaborates on this view. The private sector alternative gives market discipline and allows for maximum innovation.

Because of the Fed's role as a Government agency with privileges accorded to no private institution, and the conceptual and practical difficulties in setting a price for its services, attention should also be paid to what services should be provided by the Fed as well as the price that should be paid for them. Only when this is clearly agreed upon and understood by the Fed, the Congress, and the private sector, can a fair and sensible balance be achieved between the Federal Reserve and the private sector as providers of payments services.

ARBITRARY DISCRIMINATION AMONG FINANCIAL INSTITUTIONS

Chairman Miller has recognized the competitive inequity in the reserve requirements structure of member and nonmember institutions. However, inequities which are just as harmful exist in the reserve requirements structure for existing member banks. In his testimony before this committee, Chairman Miller stated that his proposal for universal reserve requirements would not increase regulatory burdens on nonmember banks. This statement neglects an important part of the picture. Many banks elect to have a State charter and to be a nonmember purely to avoid the excessive burdens of the Fed's reserve requirements—not because they dislike the regulatory administration of the Comptroller of the Currency or the Fed.

Should universal reserve requirements be enacted, the ultimate value of many State bank charters would be substantially diminished and many banks would over time opt to join the Fed as a national bank. Rather than substantially change the relative value of State and national bank charters, a more sensible approach is to extend reserve requirements on transaction accounts to all federally chartered depository institutions, and to those State-chartered institutions that elect to join the Federal Reserve or the Federal Home Loan Bank Board. This proposal was made by our association in S. 1668 and is discussed in the attached testimony on that bill. This alternative preserves the relative value of State and national bank charters and extends the dual banking concept, as it is known in the banking industry today, to thrift institutions as they come into the payments business.

Limitation on total interest that may be paid on reserves unnecessarily restricts the Fed's options. We caution the committee to be sure that any such limitation is realistic, and does not excessively hamper the Fed in its attempt to effectively relieve its membership burden. Setting a lower interest ceiling on required reserves over $25 million is discriminatory and we oppose it.

These proposals seem to be inspired by the view that interest on required reserves would be a "raid on the Treasury" and would, unless controlled, constitute an unnecessary subsidy to larger banks. We disagree with both points.

In the first place, reserve requirements are a tool of monetary policy. If they are to be considered a part of the Internal Revenue tax collection system, they should be discussed in that perspective.

Second, from a theoretical standpoint, there is no reason to assume that a reduction of required reserves will reduce Treasury receipts. The key determinant is the volume of reserves in the System which can be handled by Federal Reserve open market operations. Any reduction in reserve requirements can be easily offset by the Fed, and Treasury receipts are the same.

Table 1 at the end of our testimony compares Federal Reserve payments to the Federal Treasury with total Federal budget receipts in selected years. Between 1957 and 1976 the percentage of Federal budget receipts accounted for by Federal payments to the Treasury rose over 240 percent. The contribution of sterile member banks reserves to the Federal Reserve earnings constitutes a significant proportion of the total earnings.

The proportion may have declined somewhat because of the lowering of reserve requirements since 1957. But it has not declined significantly, and it seems safe to say that the contribution of sterile member bank reserves to Federal budget receipts has more than doubled since 1957.

Proponents of the thesis that interest on reserves would be a "raid on the Treasury" have, on occasion, pointed to the low effective tax rate paid by banks. This emphasis is misplaced. Those banks that pay effective tax rates substantially below the statutory rate of 48 percent do so because they take advantage of specific tax incentives designed to influence the allocation of their funds. The most important example of this is the tax exemption on municipal bonds—an exemption that has, for a long time, been basic to our system of State/Federal relations. In responding to the objectives of this exemption, banks forgo substantially higher income they might earn on taxable securities and other alternative investments. In the process, however, these banks make a significant contribution to financing the needs of State and local governments.

Another example is the investment tax credit, an incentive specifically enacted into law by the Congress for the purpose of job creation and capital formation. Through their leasing operations, banks make a significant contribution in this area. Banks are proud of their record as taxpayers and deliverers of financial services. There is no justification for discrimination against any size class of banks, or against banks as an institution vis-a-vis their competitors.

Also, declines in Federal Reserve payments to the Treasury because of reduced reserve requirements could easily be mitigated by a gradual phase-in of the program to relieve the membership burden. Of course, this would mean that it might take longer to achieve a significant alleviation of the membership burden. Nevertheless, knowledge that positive steps were being taken to relieve this burden would probably stem the membership attrition in a substantially shorter period of time.

The Federal Home Loan Bank Board is frequently viewed by thrift institutions, who are major competitors of most banks, as its "central bank" which performs many of the functions for its members that the Federal Reserve performs for its members. Members of both systems supply funds to the "central bank" and in turn receive a return on funds supplied.

Table 2 provides estimates of this return. For banks in the Federal Reserve System, the return is 2 percent—mainly an imputed return from the cost of Federal Reserve services. For thrift institutions in the Federal Home Loan Bank System, the return is 4.3 percent.

Finally, we would like to note that, although we have no objections to payments from the Fed's surplus to the Treasury, the "surplus" does not represent idle cash or current earnings, but merely an accounting entry that arises because past earnings from the use of required reserves or the provision of coin and currency have been retained and invested in other assets.

In summary, we believe the current discriminatory aspects of the reserve requirements structure are unfair and unnecessary. We oppose the compounding of this problem by additional discrimination in the interest rate paid on reserves. The emphasis being put on the relationship between Treasury revenues and the membership burden is misplaced and, in the long run, will be detrimental to both the Fed and the Treasury. The efficiency of the payments system would be greatly enhanced by explicit pricing of Federal Reserve services in a manner that recognizes the constructive and innovative role played by the private sector in the provision of payments services.

Such explicit pricing must be accompanied by an effective alleviation of the Federal Reserve's membership problem. The most promising way to do this is to reduce reserve requirements. We also support fair and impartial methods of allowing banks to earn interest on their reserves. Thank you.

[Text resumes on page 393.]

[The prepared statement of Mr. Perkins, on behalf of the American Bankers Association, along with the supporting material referred to in his oral presentation, follows:]

Statement of

the

American Bankers Association

before the

Committee on Banking, Finance, and Urban Affairs

U.S. House of Representatives

August 4, 1978

H.R.13476, the Reserve Requirements Act of 1978
H.R.13477, the Interest on Reserves Act of 1978
H.R.12706, the Federal Reserve Membership Act of 1978

Congressman Mitchell, Congressman St Germain, and members of the Committee, I am John H. Perkins, President of the Continental Illinois National Bank and Trust Company of Chicago, and President-Elect of the American Bankers Association, a trade association whose membership includes more than 92 per cent of the nation's 14,383 full-service banks. Accompanying me is Leif Olsen, Chairman of the Economic Policy Committee of Citibank, New York, N.Y. and Chairman of the Economic Advisory Committee of our association.

We are delighted to be here today to testify on the important proposals before your committee. There are few absolute certainties in any of the arguments pro and con to the proposals for change. All of us are having to speculate about living in a Federal Reserve operating environment none have experienced. The first question for consideration should not be: How do we maintain a relatively high level of membership in the Federal Reserve System? Rather, more fundamental objectives should be clearly stated. Our association believes these objectives are paramount:

--To assure the continued effectiveness of our central bank in its management of monetary policy.

--To enhance the efficiency of the payments system, and

--To eliminate arbitrary forms of discrimination against particular types of financial institutions which inhibit the delivery of banking services at least possible cost.

The proposals before you, H.R. 13476, the Reserve Requirements Act of 1978, and H.R. 13477, the Interest on Reserves Act of 1978, and H.R. 12706, the Federal Reserve Membership Act of 1978, are constructive attempts to deal with the first two concerns, although we do have some specific disagreements with them. Our third concern is barely addressed in the proposals. There appears, in fact to be an attempt to justify discrimination against larger banks on the grounds that they are not leaving the Federal Reserve as frequently as smaller banks and hence, do not deserve the same level of relief from the excessive burdens of membership. There also appears to be a belief that such discrimination will mitigate Treasury revenue losses. The first notion is simply unfair and, as we shall discuss below, the second is probably incorrect.

In discussing legislative and regulatory proposals, the policymaking bodies of the American Bankers Association attempt to discipline their thinking by asking four questions:

--How do bank customers benefit from the proposal?

--Will the proposal enhance the broad competitive environment?

--Is the proposal consistent with national economic and social priorities?

--Does the proposal achieve or maintain equal competitive ground rules among various types of competing financial institutions, and does it provide opportunity for competitive financial institutions to maintain viability and profitability regardless of size?

An attachment to this testimony analyzes the proposals before you in terms of these criteria.

We have been involved in research and discussion of the issues raised in these legislative proposals for some time. Attached to our testimony are other documents which might prove useful to the Committee and we request that they be made a part of the record of these hearings.

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2) ABA testimony before the Senate Committee on Banking, Housing, and Urban Affairs, on October 11, 1977, on the role of the Federal Reserve in providing payments services.

3) A letter from ABA to Senator Richard Lugar dated November 4, 1977, discussing the extent to which required reserves might be reduced for Federal Reserve member banks without impairing the effectiveness of monetary policy.

4) An outline of a research project the ABA will undertake to determine the impact of pricing of Federal Reserve services and relief of the Federal Reserve's membership problem on the structure of the banking industry. This outline was part of a request for proposals that was sent to various consulting firms. We are currently in the process of evaluating their proposals and hope to begin the project soon.

The Central Bank and its Management of Monetary Policy

The need for mandatory universal reserve requirements on transaction accounts held by all depository institutions in order to assure an effective monetary policy has not been demonstrated. We opposed this proposal as unjustified and likely to harm our nation's innovative system of dual banking.

The Fed has sponsored this proposal as a means of increasing the effectiveness of its monetary management. Nevertheless it should be noted that the Federal Reserve does not have universal support for its view that reserve requirements are a necessary tool for monetary policy. It is our view that reserve requirements for existing Fed member banks could be significantly lowered, and the membership burden concomitantly relieved, without any significant diminution of the Fed's ability to conduct monetary policy. To achieve this within a framework in which the Fed retains maximum flexibility to use reserve requirements for monetary policy purposes, we propose that existing statutory minimum reserve requirements be eliminated. Our views on this point are amplified in the attached letter to Senator Lugar.

It is true that the percentage of transaction accounts subject to reserve requirements of the Federal Reserve is declining. The decline of Federal

Reserve membership is only one factor accounting for this. Another is the increasing proportion of transaction accounts that are held outside the banking industry. Differing levels of reserve requirements among member and non-member institutions can cause additional instability in the money supply as deposit shares of these different categories of institutions change and money flows among them. But economists in the banking industry believe that a much greater source of instability is the graduated levels of reserve requirements among banks who are already members of the Fed. Elimination of these differences would be a significantly greater contribution to monetary stability -- and an act of simple fairness to the institutions involved.

We disagree with the proposal that would legislate inflexible reserve requirements because this would tie the hands of the Fed in its ability to use changes in reserve requirements as a tool of monetary policy. We believe, however, that existing reserve requirements levels can be reduced, and favor giving the Fed the ability to do so to the extent that it prudently can. An appropriate move for the Congress would be to set the minimum of the statutory ranges at zero, rather than setting the exact levels by legislative action.

As already stated, we believe reduction in reserve requirements should be the principal method used to alleviate the current membership burden. However, if it is administered fairly, we do support proposals calling for the payment of interest on reserves. Indeed, the two methods can be considered complementary to each other.

Limiting the payment of interest on reserves to revenues received from the pricing of services as specified in the proposed amendment to H.R. 12706, would, however, aggravate, rather than alleviate, the Fed's membership problem. This would occur because H.R. 12706 also provides for equal access for all institutions to Fed services. As Chairman Miller has already testified in these hearings, the revenue received from the pricing of services would be insufficient to effectively eliminate the membership burden. Hence, since access is available to everyone, the membership drain would be accelerated. The Fed could try to combat this by raising its prices in hopes of increasing the revenue it has available to pay interest. But if its customers were price sensitive and looked for other providers of payments services, this probably would not work.

The gathering of additional information from non-member institutions provided the data are needed for monetary policy purposes and the data gathering is done in a way that minimizes the reporting burden placed on those institutions has our support.

We do not support tying the level of the discount rate to the Treasury bill rate because this would also tie the hands of the Federal Reserve in the use of this tool for monetary policy purposes. We understand the concern supporters of this provision have over "arbitrage profits." Indeed it is quite natural for bankers to pay attention to interest rate spreads between the funds they receive and the funds they lend. This is the guts of their business. Nevertheless, in addition to power to set the discount rate, the Fed has administrative controls on the use of the discount window which we believe are sufficient and appropriate. Also, the total earnings of the Federal Reserve from the use of the discount window are only $40 million. We believe the bulk of this represents earnings on legitimate loans. The earnings of the banking industry are approximately $8.9 billion and those of the Federal Reserve System are approaching $6 billion. Surely any unnecessary "arbitrage" profits are very small relative to the earnings of the banking industry and the Fed. It seems more prudent to let the Fed retain flexibility in the use of this tool.

While we do not agree with all of the specifics of the various proposals to solve the Fed's membership problem, we continue to believe that, for the foreseeable future, a strong membership base will be very important to the conduct of monetary policy. The problem is urgent and attention should be paid to it as soon as possible. We are acutely aware that the cost of Federal Reserve membership is an important item on the current agenda of bank board meetings all across the country. As Chairman Miller pointed out in testimony before this Committee in these hearings, and as Secretary Blumenthal pointed out in hearings last year on S. 1664 and S. 1668 which dealt with the membership problem, the longer the problem continues, the more banks will withdraw from the system and Treasury revenues from that source will decline anyway. Limiting the options available to relieve the membership burden because of concern over current Treasury revenues could be penny-wise and pound-foolish. By the Federal Reserve's own estimate, withdrawals from the Fed since 1970 reduced Federal Reserve payments to the Treasury in 1977 by nearly $200 million from what they otherwise would have been. The problem is long run. It is structural. It is continuing. And it should be solved.

Enhancement of the Efficiency of the Payments System

We believe the efficiency of the payments system would be greatly enhanced if the Federal Reserve charged for its services. However, we must note that we foresee several difficulties in pricing of existing Federal Reserve services and the provision of new ones. The problem of determining proper cost allocations is difficult enough for private firms. If the Fed decides to take into account its own costs in setting its prices, as it most certainly should, the situation is substantially more difficult. How does one allocate overhead costs among such diverse activities as the administration of monetary policy through open market operations, the provision of services as fiscal agent for the Federal Government, the supervision of state-chartered member banks, the regulation of bank holding company activities, and the provision of payments services which also can be provided by private banks? Even if all the relevant data were known, we can think of no way to do this on a rational basis. Indeed, as new payments systems evolve, it becomes more and more difficult to even know the relevant data.

The provision of payments services is the main banking area in which the Fed competes directly with the private banking system. Yet with 12 regional banks, each having several branches which serve primarily as operations centers, the Fed already has a nationwide system of operations centers in place. There is no way a single bank can match this capability under the current banking structure. This makes accurate comparisons of the public and private clearing systems more tenuous.

The proposal to limit payment of interest on reserves to revenue received from pricing would diminish rather than enhance the efficiency of the payments system. We have already discussed why it would accelerate the membership drain. This accelerated loss of membership might cause the Fed to become more aggressive in providing new services in an attempt to raise pricing revenue so as to be able to alleviate more of the membership burden. If it believed its customers were price-elastic it could, to the extent Congress and its auditors permit it, undercut the private sector in an attempt to raise its revenues in order to pay more interest on reserves and achieve a greater alleviation of its membership burden. Neither of these responses would enhance the efficiency of the payments system, and it is not clear that either of them could ever enable the Fed to achieve an effective elimination of its membership burden.

We are somewhat dismayed by the Federal Reserve's comment that if universal reserve requirements were enacted the Board would have to reevaluate its program to reduce the cost burden of required reserves, and price its services. We believe the Fed should reduce the cost burden of reserves and price its services regardless of the structure of reserve requirements among depository institutions.

Such a program, if properly constructed, would greatly enhance the efficiency of the payments system without significantly diminishing its ability to conduct monetary policy.

It is our strong belief that an efficient payments system will be maintained only if there is a strong, healthy, private-sector alternative to payments services provided by the Fed. To insure this, we would propose two rules to which the Federal Reserve should be bound in setting its prices:

1. Fed prices should not be less than fully allocated costs, including allowances for overhead, cost of capital , and taxes.
2. Fed prices should not be less than what the private sector would charge for similar services.

Although these standards would be difficult to enforce, they are not mutually exclusive, and both should be used in the evaluation of Fed prices. If this is done in a fair and impartial manner, the efficiency of the payments system will be greatly enhanced. Our testimony before the Senate Banking Committee on October 11, 1977 (copy attached) elaborates on this view.

Because of the Fed's role as a government agency with privileges accorded to no private institution, and the conceptual and practical difficulties in setting a price for its services, attention should also be paid to what services should be provided by the Fed as well as the price that should be paid for them. Only when this is clearly agreed upon and understood by the Fed, the Congress, and the private sector, can a fair and sensible balance be achieved between the Federal Reserve and the private sector as a provider of payments services.

<u>Arbitrary Discrimination Among Financial Institutions</u>

Chairman Miller has recognized the competitive inequity in the reserve requirements structure of member and non-member institutions. However, inequities which are just as harmful exist in the reserve requirements structure for existing member banks. In his testimony before this Committee Chairman Miller stated that his proposal for universal reserve requirements would not increase regulatory burdens on non-member banks. This statement neglects an important part of the picture. Many banks elect to have a state charter and to be a non-member purely to avoid the excessive burdens of the Fed's reserve requirements -- not because they dislike the regulatory administration of the Comptroller of the Currency or the Fed. Should universal reserve requirements be enacted, the ultimate value of many state bank charters would be substantially diminished and many banks would over time opt to join the Fed as a national bank. Rather than substantially change the relative value of state and national bank charters, a more sensible approach is to extend reserve requirements on transaction accounts to all federally chartered depository institutions, and to those state chartered institutions that elect to join the Federal Reserve, or the Federal Home Loan Bank Board. This proposal was made by our Association in S. 1668 and is discussed in the attached testimony on that bill. This alternative preserves the relative value of state and national bank charters and extends the dual banking concept, as it is known in the bank industry today, to thrift institutions as they come into the payments businsss.

Limitation on total interest that may be paid on reserves unnecessarily restricts the Fed's options. We caution the committee to be sure that any such limitation is realistic, and does not excessively hamper the Fed in its attempt to effectively relieve its membership burden. Getting a lower interest ceiling on required reserves over $25 million is discriminatory and we oppose it.

These proposals seem to be inspired by the view that interest on required reserves would be a "raid on the Treasury" and would, unless controlled, constitute an unnecessary subsidy to larger banks. We disagree with both points.

Table 1 at the end of our testimony compares Federal Reserve payments to the Federal Treasury with total Federal Budget receipts in selected years. Between 1957 and 1976 the percentage of Federal budget receipts accounted for by Federal payments to the Treasury rose over two hundred and forty per cent. The contribution of sterile member banks reserves to the Federal Reserve earnings constitutes a significant proportion of the total earnings. The proportion may have declined somewhat because of the lowering of reserve requirements since 1967. But it has not declined significantly, and it seems safe to say that the contribution of sterile member bank reserves to federal budget receipts has more than doubled since 1957.

Proponents of the thesis that interest on reserves would be a "raid on the Treasury" have, on occasion, pointed to the low effective tax rate paid by banks. This emphasis is misplaced. Those banks that pay effective tax rates substantially below the statutory rate of forty-eight per cent do so because they take advantage of specific tax incentives designed to influence the allocation of their funds. The most important example of this is the tax exemption on municipal bonds--an exemption that has, for a long time, been basic to our system of state-Federal relations. In responding to the objectives of this exemption, banks forego substantially higher income they might earn on taxable securities, and other alternative investments. In the process, however, these make a significant contribution to financing the needs of state and local governments. Another example is the investment tax credit, an incentive specifically enacted into law by the Congress for the purpose of job creation and capital formation. Through their leasing operations, banks make a significant contribution in this area. Banks are proud of their record as taxpayers and deliverers of financial services. There is no justification for discrimination against any size class of banks, or against banks as an institution vis-a-vis their competitors.

Also, declines in Federal Reserve payments to the Treasury because of reduced reserve requirements could easily be mitigated by a gradual phase-in of the program to relieve the membership burden. Of course, this would mean that it might take longer to achieve a significant alleviation of the membership burden. Nevertheless, knowledge that positive steps were being taken to relieve this burden would probably stem the membership attrition in a substantially shorter period of time.

The Federal Home Loan Bank Board is frequently viewed by thrift institutions who are major competitors of most banks, as its "central bank" which performs many of the function for its members that the Federal Reserve performs for its members. Members of both systems supply funds to the "central bank" and in turn receive a return on funds supplied. Table 2 provides estimates of this return. For banks in the Federal Reserve system the return is 2.3 per cent -- mainly an imputed return from the cost of Federal Reserve services. For thrift institutions in the Federal Home Loan Bank System the return is 4.0%.

Finally, we would like to note that, although we have no objections to payments from the Fed's surplus to the Treasury, the "surplus" does not represent idle cash or current earnings but merely an accounting entry that arises because past earnings from the use of required reserves or the provision of coin and currency have been retained and invested in other assets.

In summary, we believe the current discriminatory aspects of the reserve requirements structure are unfair and unnecessary. We oppose the compounding of this problem by additional discrimination in the interest rate paid on reserves. The emphasis being put on the relationship burden is to be misplaced and, in the long run, will be detrimental to both the Fed and the Treasury. The efficiency of the payments system would be greatly enhanced by explicit pricing of Federal Reserve services in a manner that recognizes the constructive and innovative role played by the private sector in the provision of payments services. Such explicit pricing must be accompanied by an effective alleviation of the Federal Reserve's membership problem. The most promising way to do this is to reduce reserve requirements. We also support fair and impartial methods of allowing banks to earn interest on their reserves.

Table 1

Federal Reserve Payments to the Treasury
as a Per Cent of Federal Budget Receipts

(1) First Year	(2) Payments to Treasury by Federal Reserve	(3) Federal Budget Receipts	(4) Federal Reserve Payments to Treasury as a Per cent of Federal Budget Receipts
1957	543*	79,990	.67%
1962	718	99,676	.72
1967	1,805	149,552	1.21
1972	3,252	208,649	1.56
1977	5,908	356,861	1.66

Source: Treasury Bulletin

*Calendar Year 1957

Table 2

Return on Funds Supplied by Member Institutions to the Federal Home Loan Banks and the Federal Reserve Banks

	Federal Reserve System (Millions)	Federal Home Loan Bank System (Millions)
Funds Supplied by Member Institutions	24,088	7,438
Capital Stock (millions)	1,029	3,295
Reserves	26,709	0
Deposits	0	4,143
(less float)	3,650	
Return on Funds	490	321
Dividends	60	146
Interest on Deposits	0	175
Services (at cost)	430*	0
Precentage Return on Total Funds Supplied	2.0%	4.3%

*Federal Reserve's estimate of the cost of providing check clearing (including ACH) and coin and currency services.

Source: Board of Governors of the Federal Reserve System, 64th Annual Report, Federal Home Loan Bank System, Savings and Home Financing Source Book, Federal Home Loan Bank Board of Journal, April, 1978.

ANALYSIS OF THE PROPOSALS BEFORE THE COMMITTEE

H.R.13476, the Reserve Requirements Act of 1978

The extension of reserve requirements to non-member banks would hurt those banks and diminish their ability to serve their customers. Its effect on the competitive environment is unclear. Although some competitive inequities would be eliminated, the substantial inequities in the existing reserve requirements structure would be maintained. In addition, the value of many state bank charters would be substantially diminished thereby putting those banks at a competitive disadvantage. Although the proposal does address the Fed's membership problem in a rather oblique way, we believe there are substantially better ways of doing this. The proposal might enhance the ability of the Federal Reserve to conduct monetary policy, but we would believe this effect is small. The ability of small institutions to compete would be diminished by burdening them with excessive reserve requirements. The bill recognizes this by exempting the first $5 million of transaction accounts from reserve requirements. But there is still no reason to impose additional burden on larger non-member banks, The problems addressed by H.R.13476 can be handled be better in other ways.

We oppose H.R.13476.

H.R.13477, The Interest on Reserves Act of 1978

In terms of our criteria, bank customers of banks that achieved significant relief from membership burden would benefit. Others would not. The proposal would make the competitive environment more equitable for some institutions (those that achieved significant membership burden relief,) and less equitable for others (those that were discriminated against in the payments of interest.) Current Treasury revenue losses would be limited, but in the long run they might increase if the membership problem is not solved. The proposal provides specifically for one type of discrimination against larger banks--the two per cent interest limitation--and gives an incentive for providing another--the limitation on total amount of interest paid. For these reasons, we cannot support it.

H.R.12706, the Federal Reserve Membership Act of 1978

H.R.12706 offers potential for substantially improving the efficiency of our payments system and achieving a significant reduction in the burden of Federal Reserve membership. Customers of all banks would benefit from the first achievement and customers of the Federal Reserve member banks would benefit from the second, as the reduced level of Federal Reserve membership costs was passed on to them. The broad competitive environment would be enhanced by achieving a greater equality between member and non-member institutions in the cost of carrying reserves, and a greater equality between the Fed and the private sector as providers of payments services. National priorities would be served by allowing the Fed to retain an adequate membership base for monetary policy purposes within the framework of an efficient payments system. There would be some initial decline in Treasury revenues due to the payment of interest on reserves which can be offset by phasing in the program, and the decline in Treasury revenues due to the erosion of Federal Reserve membership would be stopped. The ability of financial institutions to compete regardless of size would be retained.

We support H.R.12706. The alleviation of the burden of Federal Reserve membership which the proposal seeks could also be achieved by a significant reduction in reserve requirements. We recommend this approach as a preferable method, and one that could be used in conjunction with H.R.12706.

Proposed Amendment to H.R.12706

This amendment has five provisions:

1) Interest paid on reserves would be limited to the sum of receipts from the pricing of services and earnings on discounts and advances.

2) Specific statutory reserve requirement levels would replace the current statutory ranges within which the levels may be set by the Fed.

3) The discount rate would be set equal to the average yield on treasury bills with less than 92-day maturities during the previous two weeks.

4) The Federal Reserve would be authorized, as it deems necessary for the conduct of monetary policy, to obtain summary statistics on assets and liabilities of all depository institutions.

5) The Federal Reserve would be directed to pay to the Treasury $575 million from its surplus within 24 months of enactment with $300 million to be paid in the first year.

Bank customers would not benefit from the first three provisions of this amendment. The efficiency of payments system would be reduced. The Federal Reserve's membership problem would not be alleviated, and the effectiveness of the monetary authority would probably be diminished. The competitive environment would not be enhanced and national priorities would not be served. Since the membership problem would not be alleviated, equality of competitive ground rules among competing institutions would not be achieved.

We support the fourth provision, if it is deemed necessary for monetary policy purposes, and the additional regulatory burden placed on banks is minimized.

For reasons explained in the text, the fifth provision has little real significance, although we have no objection to it.

Statement of W. Liddon McPeters

on Behalf of the American Bankers Association

before the

Subcommittee on Financial Institutions

of the

Senate Committee on Banking, Housing

and Urban Affairs

June 21, 1977

Mr. Chairman and members of the Subcommittee, I am W. Liddon McPeters, President of the Security Bank of Corinth, Mississippi, and President of the American Bankers Association, a trade association whose membership includes approximately 92% of the nation's 14,000 banks.

We are here today to discuss legislation introduced as a response to a variety of economic and technological changes that have taken place in our society, and some more specific responses to these changes by legislators and financial regulators. The two primary bills we will discuss have been put forward by the Administration (S. 1664) and the American Bankers Association (S. 1668). A comparison of these two bills is given in Appendix I. We wish to express our thanks to you, Senator McIntyre, for introducing our bill and allowing us to give legislative expression to our views. We have three goals we are trying to achieve with S. 1668. We want to remove competitive inequities which discriminate against bank customers. We want to make consumers savings accounts more useful. And we want to alleviate some of the factors which have made Federal Reserve membership unattractive to an increasing number of banks.

The most important competitive inequity for banks and bank customers is the differential between the maximum interest rates on time and saving deposits allowed at thrift institutions and banks. This differential is currently mandated by law. We wish to see the administration of interest rate ceilings returned to the regulators. We also believe that those thrift institutions which gain the advantage of "one-stop retail banking" through the use of third payment powers will, in effect, become banks. As such, they should be limited to the same interest rate ceilings on all classes of deposits as banks, which are their direct competitors.

We wish to make savings accounts more useful by expanding the range of options open to consumers in making third-party payments.

Also, we believe some of the conditions that have made Federal Reserve membership less attractive to an increasing number of banks in recent years should be alleviated.

We believe these goals serve the public interest, and that we are proposing a fair and equitable way of achieving them. The specific elements of our proposal are embodied in S. 1668. They are:

(1) interest is to be allowed on savings accounts used to pay third parties (by check or any other means) subject to restrictions specified below;

(2) holders of these interest bearing transaction accounts must be individuals;

(3) interest payments must not exceed specified rate ceilings;

(4) any institution offering third party payment accounts must be subject to the same rate ceilings on all accounts they offer which are subject to rate ceilings;

(5) a uniform rate ceiling on third party payment accounts offered by all depository institutions is to be set by the Federal Reserve;

(6) consultation on rate ceilings for all depository institutions should include the National Credit Union Administration;

(7) rate ceilings on other accounts at insured credit unions should be set by the National Credit Union Administration subject to items (4) and (6) above;

(8) Federal Reserve member banks, members of the Federal Home Loan Bank System, and Federal credit unions must maintain reserves against third party payment accounts as set by the Federal Reserve. Other institutions should be subject to reserve requirements set by states;

(9) all reserves required by the Federal Reserve should be held as vault cash or at a Federal Reserve bank, except that Federal Home Loan Bank System members may hold reserves at a Federal Home Loan Bank if it, in turn, holds these reserves balances as vault cash or at Federal Reserve banks;

(10) Statutory reserve ranges on all classes of deposits at Federal Reserve member banks should be revised downward.

(11) Federal Reserve banks should be allowed to pay interest on reserves, and if they do so, the rate should be uniform on all reserves held;

(12) the Interest Rate Control Act should be extended to December 15, 1980, but the statutory interest rate differential should be removed.

(13) S. 1668 would take effect 60 days after enactment in New England, and after one year in other states.

We believe that S. 1668 is a progressive response to a series of economic technological, legal, and regulatory changes that have been taking place in our financial sytem for some time. Before elaborating in detail on the reasons for our specific proposals, it may be useful to review some of the these changes, and the legislative and regulatory responses that have brought us to this point.

First, we live in an era of high interest rates. Present rates are substantially higher than those that existed in 1933 when the prohibition of interest payments on demand deposits was first enacted. High interest rates have caused consumers, businesses, and bankers to attempt to get more value for the balances they hold. Consumers have sought, and received, implicit interest in the form of lower service charges, and other forms of bank services. Businesses have been even more sophisticated in seeking such services as payroll and data processing assistance, financial advice, and better lines of credit at more favorable interest rates. Federal reserve member banks have become increasingly dissatisfied with the large amounts of sterile balances held at Federal Reserve banks, and many have left or are contemplating leaving the Federal Reserve System.

Low services charges on checking accounts, rapid economic growth, and the increasing sophistication of our financial system have prompted what many perceive to be an excessive use of paper checks. This has aggravated cost pressures on banks and prompted a variety of legal and technological responses. The burgeoning use of paper checks has also been perceived as a misallocation of economic resources which should be corrected by a lifting of restrictions on the pricing of checking accounts.

The leadership of the banking industry is pursuing a constructive response to these events. We believe the pressures described above will continue to force a rapid pace of change, and are seeking Federal legislation because the public interest will be served best by imposing a rational order on the process of change for all financial institutions.

We are seeking the imposition of a rational order to end what can best be described as "piecemealing". At first glance, piecemealing may seem to have some advantages. It obviates the need for a more comprehensive legislative design without the certain knowledge of where market pressures are leading us. It allows for different responses by different states, regulators, and institutions, depending on their interpretation of the problem. These varying responses may in turn, facilitate innovation and enable all parties to see more clearly where the financial system is headed.

However, piecemealing also has many disadvantages. As the process has evolved, competitive inequities have arisen which discriminate against the customers of different types of financial institutions. Equally important are the problems caused by uncertainty over the character and direction of change and the myriad of approaches for dealing with it. These problems have made planning by financinal institutions extremely difficult.

A Federal solution is needed. Problems of discrimination against bank customers can be addressed in a uniform manner throughout the nation. Issues that are uniquely national in nature, such as the Federal Reserve's membership problem, can be considered as part of this package.

We realize that a Federal solution also has inherent dangers. A consensus may be much more difficult to achieve. If the end result is bad, competitive inequities may be perpetuated throughout the nation. Innovation may be stifled. Such legislation, occurring at the Federal level, may be difficult to change. This is the kind of result we foresaw in the Financial Reform Act of 1976 that was considered in the House of Representatives, and that is why we opposed that legislation after four years of continually advocating constructive and equitable change.

Having considered all of these factors, our membership has decided that only through a Federal solution, can the rational order we seek be imposed on the process of change. With such a solution, financial institutions will be able to understand better the rationale of the regulators that govern them. They will be able to plan better to serve their customers. Consumers will be able to make more rational choices among a wider range of financial services. In general, the public interest will be served better. We believe a constructive and equitable version of such a solution is contained in S. 1668. The Administration has proposed S. 1664 which is also constructive and forward-looking. We support its general thrust, although we have some specific disagreements with it. I would now like to turn to a more detailed discussion of S. 1668, the problems that led us to propose it, and to comment on the Administration's proposal, S. 1664.

Interest on Consumer Transactions Balances

A central element in the bills we are discussing is the proposal to allow consumers to earn interest on transactions balances. Savings accounts would be made more useful by liberalizations of the law which would let depository institutions offer consumers savings accounts with many of the attributes they traditionally look for in checking accounts. Measures to make savings accounts more useful are part of a trend that has been going on for some time. The NOW account, a savings account on which negotiable orders of withdrawal may be written, is only one example. Others include, telephone tranfers from savings to checking accounts, the payment of bills from a savings account through preauthorized withdrawal by the depositors' instruction, the payment of bills from a savings account through telephone authorization of withdrawal by the depository institution, use of manned remote service units which initiate an electronic transfer of funds, automated teller machines to withdraw savings account money to pay bills or obtain funds, and finally, share drafts at credit unions. Appendix II shows the growth of many of these powers at banks, thrift institutions, and credit unions. It illustrates the response of state legislators, state and Federal regulators, and to some extent, the Congress to the pressures which have been moving our financial system toward interest-bearing transaction accounts.

In the same vein, the American Bankers Association for several years has sought from Federal regulators the power to allow bank customers to make preauthorized transfers from savings accounts to checking accounts, in the event that their checking account balance fell below a pre-specified level. We still believe regulators should allow such transfers. If they did some consumers would probably prefer this method over the NOW account. Others would not.

S.1664 uses the term "NOW account," and "share draft," and then goes on to say that any account which is used to "provide funds directly or indirectly for the purpose of making payments or transfers to third parties," may be defined as a NOW account, or share draft account by the Federal Reserve. Such an account would then be subject to the same regulations as NOW accounts and share draft accounts. S.1668 has similar language, but it does not attach a specific term--e.g., "NOW" -- to the account. We believe that financial institutions should have the opportunity to name these accounts in any manner they see fit.

The important point is that all savings accounts from which third party transfers are made should have the same interest rate ceilings whether they are called "NOW accounts,""share draft accounts," "Savings accounts," or anything else.

S.1668 restricts interest-bearing transaction accounts to natural persons who are making payments for personal purposes. S.1664 says these accounts may also be held by non-profit organizations. This is unnecessary and should not be a part of the legislation. In terms of their payments needs, and the services they obtain from banks, non-profit organizations are more similar to businesses than individuals and should likewise be excluded.

The immediate impact of interest on transactions balances would be a cost increase to institutions that hold the balances. This in turn would spur attempts to offset this impact. Institutions might attempt to achieve greater operating efficiencies, charge higher loan rates, change their asset mix to achieve higher yields, or adjust charges for consumer services. If no offset can be found, the result will be reduction in bank earnings. In the long run, this latter result is not healthy for the banking system and could be inimical to its attempts to serve the public needs. This nation has about 14,000 banks which compete very strongly for consumer deposits with each other, and also compete with approximately 5,000 savings and loan associations, 500 mutual savings banks, and 23,000 credit unions. It is highly unlikely that, in the long run, any of these institutions could suffer a significant decline in earnings without seriously impairing their ability to grow and serve the needs of the public. Thus, the manner in which financial institutions adjust to their changed environment will be determined by the necessity to recover all costs associated with interest on transaction balances.

Many observers have been watching the New England experience with NOW accounts very closely. They see both good and bad aspects of this experience. The rapid growth of NOW accounts in New England indicates that consumers are accepting them, and like them. However, the advent of the NOW account did bring a drastic change to the way financial institutions do business with consumers. The adjustment has been, in many instances, difficult and painful. The competitive situation was particularly difficult in Massachusetts and New Hampshire in the early years of the NOW account experiment. Unfamiliarity with the new type of account prompted many thrift institutions to offer them free of charge in an attempt to draw deposits from commercial banks. In the other New England states pricing has been somewhat more realistic and the impact of NOW accounts has not been as severe.

Our Association recently contracted with the Management Analysis Center of Cambridge Massachusetts to study the impact of NOW accounts, particularly as they interact with the interest rate differential enjoyed by thrift institutions over banks. As yet, we only have a preliminary summary report. It indicates some significant findings. The initial cost impact of NOW accounts is greater on banks than on thrift institutions. Their results indicate that in Massachusetts and New Hampshire banks suffered a decline in profitability relative to banks in the rest of New England, and in the United States as a whole. They also suffered a more severe decline in profitability than thrift institutions in the same states.

On January 31, 1977, the Federal Reserve Board submitted to your Committee a paper entitled "Impact of the Payment of Interest on Demand Deposits." This study represented a major contribution to the consideration of this subject. Because of some reservations we had about the study, the American Bankers Association contracted with Golembe Associates of Washingtin, D.C., to do a critical review of it, and some further research in some of the areas about which we had reservations. This Golembe study agrees with us that the Federal Reserve study is very well done and is an excellent contribution to your Committee's deliberations. However, it also states that the Fed study seriously underestimates the probable magnitude of earnings pressures on banks and fails to devote attention to the differences in probable impacts among individual institutions.

We do not think any of this research indicates that NOW accounts should be declared illegal, or even prevented from spreading nationwide. However, it does illustrate the need for a good monitoring system by regulators and a removal of the competitive inequities which would aggravate the pressures on banks, if NOW accounts were allowed nationwide.

Knowledge of the experience of New England bankers has caused bankers nationwide to view the current spate of proposals for financial reform with mixed feelings. These banks are concerned about the earnings of their institutions, and we believe this concern serves the public interest. Our country is just emerging from a bout with double digit inflation and the worst recession since the 1930s. Despite some individual mistakes, the banking industry served the public very well during this difficult and trying period. Many individuals and businesses were severely hurt by this economic instability and managed to weather the storm only through the forbearance of their bankers. The result, for many banks, was a decline in earnings and capital positions. In addition, as Governor Henry Wallich of the Federal Reserve has recently pointed out, the double digit inflation drastically overstated the true value of banks' earnings. Earnings are a particularly crucial element in the programs of many banks to rebuild their capital positions. The key role that banks play in our economy necessitates that the proposals being considered be structured to enable the banking industry to continue to grow and prosper.

The monitoring problem is particularly important in the case of credit unions. There are more credit unions in our country then any other type of depository institution. A credit union is the easiest kind of depository institution to create, and since their beginning, Federally chartered credit unions have experienced considerably higher rates of failure and liquidation than banks. Credit union regulators have not had substantial experience in examining institutions that are in the payments business. We urge the Committee to accord careful attention to this area.

Efficiency of the payments system is one of the goals long put forth by proponents of the payment of interest on checking accounts. Efficiency is a goal we heartily endorse. Although the precise effect of the proposed legislation on the efficiency of the payments system is not completely known, the direction seems clear. Interest on consumer transactions balances will probably prompt higher service charges and encourage people to cut down on the use of checks. This in turn will spur a more rapid development of electronic funds transfer systems, which many consider to be more efficient. It should be remembered, however, that consumers are familiar with our system of paper check-writing, and like it. Some might reject a trade-off that involved higher service charges in exchange for explicit interest. In some areas of New England a pattern has developed whereby service charges and balance requirements on NOW accounts are substantially higher than those on checking accounts. How this will affect total numbers of checks written remains to be seen. It is our view, however, that the lifting of restrictions as proposed in S.1664 and S.1668 will, in the long run, enhance the efficiency of our payments system. How much, and in what form, is not yet known.

An area of the proposed legislation we have considered very carefully is its impact on depositors. It seems clear that initially, smaller depositors would not be helped by the advent of NOW accounts. Almost all bankers tell us that the ratio of the number of checks written to the average account balance declines as the average balance increases. This means smaller account holders would have the least to gain, and probably even lose somewhat, from a system which pays interest and increases the charge per check. Of course, it is not clear that higher service charges will be imposed in exactly this manner. Moreover, such a system would probably spur the development of electronic funds transfer systems which could become a great boon to small depositors. Also, the problem of small depositors may be alleviated if service charges are structured so that depositors who write large numbers of checks have an incentive to keep their balances in low-service charge, non-interest bearing accounts.

We suspect some consumers will choose an explicitly priced checking account, such as a NOW account, even thought they might suffer a monetary loss in the trade off between interest rates and service charges. To some people, more exact knowledge of the value of the benefits they receive from checking account services would be useful. Others, we suspect, will continue to choose an implicitly priced account. The important point is that the lifting of restrictions, as proposed in S.1664 and S.1668, will enable banks to offer both types of accounts to consumers, who will then be able to make a choice.

Competitive Equality - Interest Rate Ceilings

Recent legislative and regulatory action at the Federal and State levels has given thrift institutions many of the same asset and liability powers as commercial banks without requiring parity with respect to interest rate ceilings, reserve requirements, and treatment of reserves. In some parts of the country, thrift institutions already have third party payment powers similar to the interest-bearing transaction account being proposed in both S.1664 and S.1668. However, these institutions still retain the interest differential on time and savings accounts

We believe the granting of third party payment powers to thrift institutions blurs the remaining differences between financial insitutions to such an extent that the advantage of the interest rate differential should be removed from all classes of time and savings accounts at any institution which elects to offer third party payment accounts. S.1668 prescribes that any thrift institution which decides not to offer third party payment accounts would retain the advantage of the differential, despite our continued objection to this form of discrimination against bank customers.

S.1668 prescribes that, on the effective date of the bill, credit unions offering share drafts would be subject to the same interest rate ceilings on all accounts. This is the same treatment prescribed for any other institution offering third party payment accounts. There is no reason to "grandfather" the interest rate ceilings on credit union accounts as is done in S.1664.

Bill paying services, transfers from remote terminals, and other ways of transferring money from savings to checking accounts are already increasing the convenience of keeping transactions balances in thrift institution savings accounts. And even if third party payment accounts had the same interest rate ceiling at all institutions, thrifts would have the advantages of both one-stop banking and higher interest rates on time and savings accounts if they retained their differential on these accounts.

The decline in commercial banking's share of the time deposit market, excluding regular savings and bank time deposits over $100,000, as shown in Table 1, reflects the interest sensitivity of these deposits. In contrast, regular savings deposits are less sensitive to the interest rate differential since they are often maintained for use in emergencies and must be easily transferable to transaction accounts. For many poeple, the additional inconvenience of transferring these funds from thrift institutions without third-party payment powers to a bank with third-party payment powers outweighs the higher yield available at the thrifts. However, if thrifts gain general third-party payment powers, the differential will become more important in competition for regular savings accounts. Without the elimination of the differential at thrift institutions that gain general third-party payment powers, we will see a decline in the bank market share of regular savings accounts similar to that which has already occurred in the market for consumer certificates of deposit.

The market for Individual Retirement Accounts (IRAs) is another example of how the interest rate differential has placed banks at a competitive disadvantage. In announcing its decision to allow member banks to pay the same deposit interest rate as thrift institutions for IRAs, effective July 6, 1977, the Federal Reserve Board cited data from December 1976 showing commercial banks with only about 35 percent of the IRA deposit market while accounting for 47 percent of the total household time and savings deposits. When you consider that savings and loan associations have less than 25 percent of the total savings locations, the importance of the 1/4 percent interest rate advantage on IRAs as well as all household time and savings deposits becomes even clearer.

Although the regulated differential introduced in the Interest Rate Control Act of 1966 was established to help maintain the flow of funds to the housing market, the differential may hurt thrifts more than other institutions during periods of disintermediation. Since a greater proportion of interest sensitive funds is at thrifts because of the differential, a greater percentage of thrift deposits may flow into unregulated money market instruments when interest rates are rising.

Individuals who have an opportunity to save at a thrift institution, but choose instead to save at a commercial bank by opening a savings account or buying a certificate of deposit, are being discriminated against.

Bank customers have benefited or will benefit from the elimination of the differential on:

1) Time deposits of governmental units (1974)
2) NOW accounts in Massachusetts and New Hampshire (1974)
3) Long-term retirement accounts (1977)
4) Interest-bearing transaction accounts as proposed in both S.1664 and S.1668

Bankers are well aware of the justification given in many quarters for the interest-rate differential--namely, that thrift institutions specialize in housing more than banks do. In addition to our feelings about discrimination against bank customers, we have two objections to this rationale for the differential.

First, as mentioned above, the interest rate differential has made thrift institutions particularly prone to outflows of funds during periods of rising market interest rates. This instability in the thrift institution deposit base has been a disruptive force in the mortgage market.

Second, the implication of many of the arguments in favor of the differential is that banking is not making a significant contribution to housing finance. This is not true. As shown in Table 2, banks held $83.7 billion in mortgages at the end of the first quarter of 1976, more than any other class of institutions, except savings and loan associations. In addition, banks make a substantial contribution to housing finance through such means as home improvement loans, the purchase of Federal housing agency obligations, and similar investments. Some of these investments are shown in Table 3, as of the first quarter of 1976.

Over the longer run, as Table 5 shows, the percentage of total assets that thrift institutions have been holding in the form of mortgages has been trending downward, while that of banks has been going up. Indeed, between 1965 and 1976, the percentage of total assets of mutual savings banks in the form of mortgages declined from 76.3 to 60.6. Also, as indicated in Table 4, in both 1975 and 1976 a substantial portion of the increase in deposits at thrift institutions was not put into housing. For mutual savings banks, deposits grew at more than twice the rate of mortgage investments in both years.

We are proud of the record of our industry in housing finance. From the standpoint of housing finance there is no justification for the discrimination against bank customers inherent in the interest rate differential.

Competitive Equality - Reserve Requirements and Treatment of Reserves

While parity on reserve requirements and treatment of reserves is also important to the competitive balance between financial institutions, we believe each State should continue to have the authority to set reserve requirements for state-chartered depository institutions that are not members of the Federal Reserve System, or the Federal Home Loan Bank System.

The Federal Reserve has pointed to the decline in the percentage of deposits in member banks (which are therefore subject to reserve requirements) as evidence that its control of the money supply is eroding. In spite of this, there is not general agreement that the Federal Reserve needs the authority to set reserve requirements for a certain percentage of deposits in order to control the money supply. Nevertheless, it is useful to determine whether the introduction of interest-bearing consumer transaction accounts would lead to a significant decline in the percentage of deposits subject to reserve requirements set by the Federal Reserve. It is assumed that the Federal Reserve's main concern is with transaction balances, that is, demand deposits and other types of interest-bearing transaction balances.

A preliminary analysis of this problem is presented in Table 6. We simulated the effect of nationwide NOW accounts with the use of deposit data from December 1975. Even a shift of as much as 40 percent of the funds currently deposited in household checking accounts at commercial banks to NOW accounts at thrift institutions, would result only in a moderate reduction in the percentage of transaction balances subject to reserve requirements set by the Federal Reserve nationwide. About half of this reduction could be offset by giving the Federal Reserve the authority to set reserve requirements on NOW accounts held at Federally chartered savings and loans. Virtually no reduction would occur if the Federal

Reserve were given authority to set reserve requirements on NOW accounts at all thrift institutions which were members of the Federal Home Loan Bank System. This results from the fact that Federal Home Loan Bank members account for about 98% of the deposits at savings and loan associations and about 20% of the deposits at mutual savings banks.

We believe S.1668 will give the Federal Reserve adequate means to control the nation's money supply. It states that the Federal Reserve should be authorized to set reserve requirements for all Federally-chartered institutions, including Federally-chartered credit unions, State member banks, and State-chartered thrift institutions belonging to the Federal Home Loan Bank System. The required reserves of these institutions should be held either at the Federal Reserve or at a depository acceptable to the Fed.

The Federal Reserve should not have the authority to determine reserve requirements for State-chartered institutions that are not members of the Federal Reserve System or the Federal Home Loan Bank System. Such institutions should continue to be subject to reserve requirements according to State law or regulation. Basically, we are asking that thrift institutions be regulated with respect to reserve requirements in the same way as banks.

The Federal Reserve's Membership Problem

In reducing the cost of Federal Reserve membership, we believe certain principles should be followed. The cost of membership should be reduced by approximately the same percentage for all sizes of banks. We support this approach because the factors which have increased the cost of Federal Reserve membership have resulted in approximately the same percentage increase in cost for members of all sizes. In fact, even though the increase in cost has been the same for all sizes of banks, the level of the cost of membership, under current reserve requirements schedules, is substantially higher for larger banks than smaller ones.

There are two elements to the cost of Federal Reserve membership. The first element depends on the interest rate a bank could earn if it were allowed to invest those reserves in earning assets. This rate of sacrificed earnings is approximately the same for all banks, and has been the major element in the rise in Federal Reserve membership costs in recent years. Since the interest rates on earnings assets are approximately the same for all sizes of banks, the rate to be paid on reserves should be the same for all sizes of banks.

The second element depends on the amount of reserves which must be held, and is larger for larger banks. On demand deposits, banks with less than $2 million in this type of deposit have a 7 percent reserve requirement, while banks with more than $400 million in demand deposits have a 16.25 percent reserve requirement. Thus, in general, the cost of Federal Reserve membership is larger for larger banks. Also, this graduated structure of reserve requirements means the normal growth in bank deposits will tend to increase the aggregate cost of Federal Reserve membership.

This member bank reserve requirement structure is an historical accident dating back more than 110 years to the creation of the national bank system. It was discriminatory at that time against banks located in money centers and justified in part by the role of these banks as quasi-central banks. That justification disappeared with the creation of the Federal Reserve System in 1914, but the geographic reserve structure continued until 1972 and is even now reflected in the law. The Federal Reserve since 1972 has required progressively higher reserve percentages as the total of demand deposits in each bank increases. There is no justification for this discrimination among member banks on the basis of size.

It has been said that payment of interest on reserves held at Federal Reserve Banks would be a subsidy to banks. This greatly oversimplifies the situation. The funds which member banks maintain in Federal Reserve Banks are invested primarily in government securities which provide interest income for the Federal Reserve. This interest income substantially exceeds the costs of providing services to member banks and a portion of it is paid to the Treasury each year. The Federal Reserve's investment income was about 5% of its assets in 1975. Thus, the Federal Reserve earned about $1.25 billion on $25 billion of reserves held by member banks.

An estimate of the total cost of Federal Reserve membership can be obtained by estimating the earnings which reserves kept at Federal Reserve banks would produce if they were invested in earning assets. Such funds would likely be used to purchase Treasury bills or held as correspondent balances. The market yield on 3-month Treasury bills averaged 5.80 percent in 1975 and about 5.00 percent in 1976. An August 1975 survey of correspondent banks in the Kansas City Federal Reserve Bank indicated an average earnings allowance on correspondent balances of about 6 percent. This was just slightly below the rate on Treasury bills at that time. Multiplying the $26.7 billion of reserves at Federal Reserve banks at the end of 1975 by the 5.8 percent average yield on Treasury bills provides an estimate of the total cost of membership of about $1.5 billion in 1975. A similar estimate for 1976 indicates a total cost of membership of about $1.3 billion. In other words, member banks could have earned about $1.5 billion more in 1975 and $1.3 billion in 1976 if they could have invested funds which they held as reserves with Federal Reserve banks.

The earnings that banks sacrifice as a result of sterile reserves held at the Fed can be viewed as a tax on banks. The amount of this tax has increased as a result of the increase in the cost of Federal Reserve membership. The increase in the cost of membership was primarily the result of an inflation induced rise in market interest rates. The proposals being discussed merely authorize the Federal Reserve to reduce the amount of this tax to levels which existed before the inflation induced rise in interest rates.

Federal Reserve membership confers benefits on those who are willing to pay the price. These include services such as check clearing, provision of coin and currency, safekeeping for securities, and access to the discount window. The Federal Reserve has also recently put out for comment a proposed regulation that would allow it to charge explicit fees for the services it offers member banks. The implementation of such a regulation would at least partially offset the reduction in the cost of membership occasioned by the payment of interest on reserves. Although larger banks use proportionately more of these services than smaller banks, we suspect the Federal Reserve would not allow a regime of explicit pricing that allowed volume discounts. Similarly, reserve requirements and interest paid on reserves held should be nondiscriminatory with respect to bank size.

Federal Reserve spokesmen have made it clear that that the Board desires the authority to pay interest on reserves as a means of making Federal Reserve membership more attractive, particularly to smaller banks. There is an implication that if the limitation on total interest payments is such as to produce a payment believed inadequate for this purpose, the Board will look favorably upon plans to pay interest to smaller member banks at higher rates or otherwise to discriminate against larger banks. This overlooks the fact that a number of nonmember banks are large (in excess of $1 billion in deposits), but it has a greater flaw in compounding what is already a discriminatory system for setting requirements against the deposits of member banks. Unless the burden of Federal Reserve membership is eased on a uniform basis across all sizes of banks, the trend toward larger and larger banks withdrawing from the system will continue. Thus, the results of discrimination may well be counter productive,for the loss of one large member bank can easily offset the attraction of many new smaller members.

The consideration of the payment of interest on reserves simultaneously with interest bearing transaction accounts is in some ways misleading for it is an easy conclusion that interest on reserves is required to cover the cost of payments to consumers. The payment of interest on member bank reserves should be viewed as a structural change in the banking system which is a long-overdue step to lessen the cost to member banks of belonging to the Federal Reserve System. This provides support to the nation's monetary authority, and should be viewed in this context.

Other Bills Being Considered

Although our statement has concentrated on only two of the six bills being considered during these hearings, we believe the conditions established in S. 1668 with respect to interest rate ceilings, reserve requirements, and treatment of reserves must be applied to many of the proposed recommendations in the other four bills. Over the last few years, our Association has had the opportunity to testify on a number of these issues before this Subcommittee and the House Subcommittee on Financial Institutions, Supervision, Regulation and Insurance. However, some of the proposals in the other four bills are new and have not been discussed in detail or acted upon by our Government Relations Council. For this reason, we can only state our tentative views at this time:

S. 1665

1. Federal Chartering of Mutual Savings Banks. Title I limits Federal status to only those institutions which are State chartered institutions at the time of conversion to a Federal charter. When conditions concerning parity on interest rate ceilings and reserves are adopted, we will be willing to support this title.

2. Management Powers of Credit Unions. Because these provisions would completely reverse credit unions' traditional service to low-and moderate-income savers and borrowers, they will make credit unions comparable to other financial institutions. We see no reason to object to this change so long as it is accompanied by the provision of S. 1668 equalizing the interest rates and reserve requirements on credit union deposit, share and other accounts.

3. Central Liquidity Fund for Credit Unions. We have no objection to this proposal as long as our conditions on interest rate ceilings and reserves are adopted in connection with the expansion of credit union asset and liability powers.

4. Restructuring of the National Credit Union Administration. We have no objection to this proposal.

S. 1666

1. Extension of the Interest Rate Control Act. We are opposed to this proposal because it is inconsistent with the changes recommended in S. 1668.

2. 100% Insurance of Public Funds. We believe this proposal is unnecessary and should not be adopted.

3. Variable Rate Mortgages. We support any experiments that may be helpful in the development of variable rate or other flexible mortgage instruments.

4. Expansion of Lending and Investment Powers under Title V of the Home Owners Loan Act. We would support the expansion of lending and investment powers for Federal savings and loan associations as long as it was accompanied by an equalization of interest rate ceilings, reserve requirements, and treatment of reserves as proposed in S. 1668.

5. Federal Chartering of Mutual Savings Banks. When our conditions on parity of interest rate ceilings and reserves are met, we will be willing to support the Federal chartering of mutual savings banks. However, we oppose this particular provision because it would allow a converting institution to begin a new line of investments just prior to conversion rather than being subject to the five year historical restriction of Title I of S. 1665.

S. 1667

Except for our opposition to the proposed extension of interest rate controls in Title I, we have no objection to the provisions of S. 1667 if parity on interest rates and reserves are also accepted.

S. 1669

We have no objection to this proposal.

The American Bankers Association has attempted to address the issues of interest-bearing transaction accounts, competitive equality among financial institutions, and the burden of Federal Reserve membership in a constructive way. I believe that S. 1668 deals directly with these major concerns. In general, we have no objection to any of these additional proposals as long as they are accompanied by parity on interest rate ceilings, reserve requirements, and treatment of reserves.

Table 1

Commercial Bank Deposit Market Shares
1970 - 1976

	Market	Percent Growth in Market 1970-75	Commercial Banks Market Share 1/		
			1970	1975	1976 2/
				Percent	
1)	All Deposits	69	68.8	66.5	64.8
2)	Demand Deposits	31	100	99.7	99.7
3)	All Time and Savings Deposits	90	51.7	53.9	52.5
4)	IPC (individuals, partnerships, and corporations) Time and Savings Deposits	86	48.3	49.6	48.7
5)	IPC Regular Savings Deposits	42	39.4	45.4	47.1
6)	IPC Time and Savings Deposits Excluding Regular Savings Deposits and Large CD's	147	49.0	40.8	na
7)	Household Time and Savings Deposits	86	46.4	47.6	na
8)	Household Regular Savings Deposits	42	40.3	44.8	na
9)	Household Time and Savings Deposits other than Regular Savings	152	56.6	50.5	na

1/ Not including Credit Union Shares.

2/ Preliminary

Sources: FDIC, Assets and Liabilities, selected dates, Federal Reserve Bulletin, selected dates, NAMSB Fact Book, selected dates, USLSA Fact Book, selected dates, Federal Reserve Board, Flow of Funds Statistics. All time and savings deposits at thrifts are assumed to be held by households. Line 6 uses data for insured commercial banks for Jan. 31, 1971 and Jan. 31, 1976. Lines 8 and 9 assume that 97% regular savings deposits at commercial banks in 1975 were held by households compared to 100% in 1970.

Table 2

Mortgage Loans Outstanding, by Type of Lender

First Quarter 1976

(Billions of Dollars)

Lender	One-to Four-Family	Multi-Family	Total
Savings and Loan Associations	$231.3	$25.9	$257.2
Commercial Banks	78.2	5.5	83.7
Mutual Savings Banks	50.3	31.9	64.2
Life Insurance Companies	17.3	19.7	37.0
All Others	126.3	35.7	162.0
Total	$503.4	$100.7	$604.1

Source: Federal Reserve Board

Table 3

The Banking Industry's Contribution
to Housing Finance

First Quarter 1976
(Billions of Dollars)

Residential Mortgage Loans	$ 83.7
Mobile Home Loans	8.7
Home Improvement Loans	5.9
Residential Construction Loans	8.1
Residential Land Loans	2.3
Federal Housing Agencies Obligations	14.5
Municipal Securities Supporting Housing	78.0
Loans to Other Housing Lenders	20.0
Total	$221.2

Source: Federal Reserve Board

Table 4

Percentage Increase in Total
Deposits and Mortgage Loans

1975 and 1976
(In percent)

	Commercial Banks	Mutual Savings Banks	Savings and Loan Associations
1975			
Increase in Total Deposits	4.6	11.3	17.7
Increase in Mortgage Loans	3.4	3.1	11.8
1976			
Increase in Total Deposits	6.0	11.8	17.5
Increase in Mortgage Loans	10.7	5.7	15.9

Sources: FDIC; National Association of Mutual Savings Banks; United State League of Savings Associations.

Table 5

Percentage of Total Assets in
Mortgage Loans,
Selected Year-End Dates,
1965 - 1976,
(In per cent)

	1965	1975	1976
Commercial Banks	13.2	14.2	14.5
Mutual Savings Banks	76.3	63.8	60.6
Savings and Loan Associations	85.1	82.4	82.4

Sources: FDIC; National Association of Mutual Savings Banks; United State League of Savings Associations

Table 6

Percent of Transaction Balances[1/] Subject to Reserve Requirements Set by the Federal Reserve

Types of Deposits Subject Reserve Requirements Set by Federal Reserve	Percent of Household Demand Deposits Shifted to NOW Accounts at Thrift Institutions			
	0%	10%	20%	40%
	Percent of Transaction Balances Subject to Reserve Requirements Set By the Federal Reserve			
All Deposits at Member Banks	76.4%	74.0%	71.6%	66.4%
All Deposits at Member Banks, NOW Accounts at Federally Chartered Thrift Institutions	76.4%	75.3%	74.2%	72.0%
All Deposits at Member Banks, NOW Accounts at Thrift Institutions which are Members of Federal Home Loan Bank System	76.4%	76.4%	76.4%	76.3%

1/ Demand Deposits held by individuals, partnerships and corporations plus NOW Accounts at all financial institutions

Assumptions

1. The ratio of IPC demand deposits at member commercial banks to IPC demand deposits at nonmember commercial banks remains constant.

2. All funds in NOW accounts at thrift institutions come from household checking accounts at commercial banks.

3. Member and nonmember commercial banks lose household demand deposits to NOW accounts at thrift institutions in proportion to their total volume of household demand deposits.

4. Different types of thrift institutions attract NOW account funds in proportion to their total time and savings deposits. Credit unions were not included in the analysis.

5. The ratio of household demand deposits to IPC demand deposits is the same for member and nonmember commercial banks.

APPENDIX I

COMPARISON OF ADMINISTRATION AND ABA BILLS

ISSUE	S. 1664 ADMINISTRATION BILL	S. 1668 ABA BILL
1. Ownership and use of NOW Accounts (See Note 2 below)	Owner must be individual or nonprofit association (including credit unions); no restriction on use (Sec. 101).	Owner must be individual and account must be used for his personal purposes (Sec. 1).
2. Fine for violations of NOW Account restrictions	Repeals fine (in rewriting 12 U.S.C. 1832, Sec. 101 omits fine).	Continues present provision subjecting institutions that violate restrictions on NOW accounts to $1,000 fine for each violation (12 U.S.C. 1832(c)).
3. Other kinds of Savings Accounts used to pay bills	Two types of accounts are authorized in Section 101. Other types would be allowed by State law or other provisions of Federal law (such as 12 U.S.C. 1464 (b)(1)). For instance, an S&L may agree to pay bills from a savings account as the saver directs over the phone. The account is not a "NOW" account as defined in the bill because no "negotiable or transferable instrument or other similar item" is used to withdraw the money. Apparently, this account would be subject to a higher ceiling unless the 4 agencies used their broad authority to treat it as a NOW account. That could be done only if all 4 agencies agreed to issue a "similar" regulation or order.	All savings accounts from which transfers to third parties may be made are subject to the same ceiling, regardless of how transfers are made (Secs. 1, 2(c), and 6).

ISSUE	S. 1664 ADMINISTRATION BILL	S. 1668 ABA BILL
4. Rate Ceilings: Uniformity	Ceilings are uniform for all NOW accounts (Sec. 104(a)), but statutory rate differential continues for other accounts (lower ceilings for commercial banks than for thrift institutions) unless changed with approval of both Houses of Congress (Public Law 94-200, 12 U.S.C. 461note).	If institution offers 3d-party-payment accounts, with or without interest, all its accounts are subject to same ceilings as banks (Sec. 6); statutory differential is repealed (Sec. 7(c)).
5. Rate Ceilings: Coverage		
Institutions insured by FDIC or FSLIC, and other FHLB members	Ceilings apply to all interest-bearing consumer deposits (existing law).	Same (existing law).
Federal credit unions	Ceilings apply to NOW accounts only (Secs. 104(a), 104(e)).	Ceilings apply to all interest-bearing consumer deposits (Secs. 2(c), 5(b), 5(c)).
Other insured credit unions	No ceilings (see note 3 below).	Ceilings apply to all interest-bearing consumer deposits (Secs. 2(c), 5(b), 5(c)).
Uninsured credit unions	No ceilings.	Ceilings apply if credit union offers 3d-party-payment accounts, with or without interest (see 3 above, Sec. 2(c)).
Other uninsured, nonmember institutions	Ceilings apply only if they hold over 20% of thrift accounts in State where no State ceilings apply (existing law).	Ceilings apply if they offer 3d-party-payment accounts, with or without interest (see 3 above, Sec. 2(c)).

ISSUE	S. 1664 ADMINISTRATION BILL	S. 1668 ABA BILL
6. Rate Ceilings: Agency responsible for setting ceilings on NOW accounts	3 of 4 agencies (FRB, FDIC, FHLB, and NCUA) must agree on NOW account ceiling, except FRB may set initial ceiling if no agreement is reached in 6 months (Sec. 104(a)).	FRB sets ceiling on NOW accounts after consulting other agencies (Sec. 2(c)).
7. Rate Ceilings: Expiration	On Dec. 15, 1979, rate ceiling authority reverts to pre-1966 law except for NOW accounts (Sec. 301). Ceilings for NOWs continue for 3 years (4 years from enactment), when they expire unless renewed during the next 3 years by vote of 3 of 4 agencies (Sec. 104(a)).	On Dec. 15, 1980, rate ceiling authority reverts to pre-1966 law (Sec. 7(a)).
8. Rate Ceilings: Grandfather clause	Over-ceiling rates on NOW accounts in existence at enactment may continue for 4 years after enactment (Sec. 104(b)).	No such provision.
9. Extension of reserve requirements to nonmembers of FRS	Reserve requirements apply to NOW accounts at all institutions insured by FDIC, FSLIC, or NCUA; all FHLB members; and uninsured savings banks (Secs. 102(a), 201(a)).	Reserve requirements apply to interest-bearing 3d-party-payment accounts at FHLB members and Federal credit unions, in addition to Fed member banks (Sec. 2(b)).
10. How reserves may be held	Reserves may be held as vault cash, at FRBank, or (for nonmembers) at intermediary FR member bank, or at FHLBank (Sec. 202(a)).	Reserves may be held as vault cash, at FRBank, or (for FHLB members) at FHLBank if it holds them as vault cash or at FRBank (Sec. 2(b)).

	ISSUE	S. 1664 ADMINISTRATION BILL	S. 1668 ABA BILL
11.	Phase-in of reserve requirements for non-members of FRS	For nonmembers of FRS, required reserves are reduced by 75% in first year, 50% in second, and 25% in third (Sec. 201(b)).	No phase-in provision.
12.	Reserves on demand deposits at FR member banks	FRB sets requirement at not more than 22% nor less than 5% (7% for banks with more than $15 million of net demand deposits) (Sec. 201(a)).	FRB sets requirement at not more than 20% nor less than 5% (Sec. 2(a)).
13.	Interest on required reserves	FRBanks may pay interest on required reserves they hold at rate fixed by FRB; payments may not exceed 10% of net earnings of FRBanks in previous year (Sec. 202(b)).	Same, except rate paid must be uniform regardless of size of reserve balance or nature of institution, and limit is 5% of required reserves held by FRBanks at end of previous fiscal year (Sec. 2(b)).
14.	FRBanks as clearing houses	FRBanks may receive "other items, including negotiable orders of withdrawal" as well as checks and drafts payable on presentation, and accept deposits from nonmembers on same terms as FR members. Nonmembers of FR must maintain clearing balances at level FRB deems "appropriate"; law now requires level sufficient to offset their items in transit. FRB may require FRBanks to act as clearing house for nonmembers of FR, and may fix charges (presumably for collecting items) that depository institutions impose on their customers whose items are cleared through FRBank (Sec. 205).	No such provisions.

ISSUE	S. 1664 ADMINISTRATION BILL	S. 1668 ABA BILL
15. Effective date	Bill takes effect one year from enactment (Sec. 206).	Bill takes effect one year from enactment, except it takes effect 60 days from enactment in New England (Sec. 8), and repeal of statutory differential takes effect on enactment (see 3 above, Sec. 7(c)).

NOTES:

1. This table is based upon reading S. 1664 and the section-by-section analysis of it in the CONGRESSIONAL RECORD. Where unclear, we have tried to resolve ambiguities by presuming the framers' intent.

2. In this table "NOW account" is used to cover other kinds of interest-bearing third-party-payment accounts (such as share draft accounts at credit unions) as well.

3. The earlier FRB draft bill applied ceilings to all credit unions insured by NCUA, not just Federal credit unions. While S. 1664 is not entirely clear on that point, the ceiling authority is inserted in a provision that relates solely to Federal credit unions, and the earlier FRB draft's reference to other insured credit unions is omitted. We assume an intent to exclude other credit unions from coverage.

APPENDIX II

DEPOSIT POWERS OF BANKS
AND THEIR COMPETITORS

BANKS

WHAT	WHERE	HOW
Checking accounts	Nationwide	
NOW accounts	MA, NH, CT, ME, RI, VT	State and Federal statutes
Telephone transfers from customer's savings accounts to checking account	Nationwide	Federal regulation
Manned remote service units or off-premise automated teller machines	State Chartered banks in: AL, AR, CO, CT, FL, GA, ID, IA, KS, KY, LA, ME, MD, MA, MT, NE, NH, NJ, NM, NY, NC, ND, OK, OR, OR, RI, SC, SD, TN, VA, WA, WI National Banks providing they comply with branching laws	State statutes and regulation

SAVINGS AND LOAN ASSOCIATIONS

WHAT	WHERE	HOW
NOW accounts	MA, NH	State statutes and interpretations; federal statute (federal s&ls)
	CT, ME, RI, VT	Federal statute
Checking accounts, Non-interest bearing NOWs	CT, IL, ME, NY, RI, WI	State statutes and interpretations
Preauthorized bill paying	Nationwide (federal s&ls)	Housing Act of 1970; Federal Home Loan Bank Board regs.
Bill paying by telephone	AR, CA, DC, FL, HI, NB, OK, PA, TX	State and federal regulations
Manned remote service units and off-premise automated teller machines	Nationwide (federal s&ls)	Federal Home Loan Bank Board regs.
	AL, CO, CT, FL, IA, KS, KY, ME, MA, MT, NH, NJ, NM, NY, RI, SC, SD, VA, WA, WI	State statutes (Kentucky by regulation)
Telephone transfers from savings in federal s&ls to demand deposit accounts	Nationwide	Federal Home Loan Bank Board regs.

MUTUAL SAVINGS BANKS

WHAT	WHERE	HOW
NOW Accounts	MA, NH	State statutes and interpretations
	CT, ME, RI, VT	Federal statute
Checking accounts, Non-interest bearing NOWs	CT, DE, IN, ME, MD, MN, NJ, NY, OR, PA, RI, VT	Charters, bylaws, state statutes and interpretations
Bill paying by telephone	CT, MA, MN, NJ, NY, PA, RI, VT, WA	State and federal regulations
Manned remote service units and off-premise automated teller machines	CT, ME, MA, MD, NH, NJ, NY, OR, RI, WA	State statutes

CREDIT UNIONS

WHAT	WHERE	HOW
NOW Accounts	MA	State statute
Checking accounts, Non-interest bearing NOWs	NV, RI, UT	State statutes and interpretations
Manned remote service units and off-premise automated teller machines	Nationwide (federal CUs)	National Credit Union Administration
	AL, CO, FL, ID, IA, MA, MT, NM, RI, SC	State statutes
Share drafts	Nationwide (federal CUs)	National Credit Union Administration
	AL, CA, CO, CT, FL, ID, IL, IN, IA, KY, MI, MN, MO, MT, NV, NC, ND, OH, OK, RI, TN, TX, UT, VA, VT, WA, WI	State statutes and interpretations
Share certificates, lines of credit, mortgage loans to 30 years, etc.	Nationwide (federal CUs)	Federal statute
	AL, AZ, CA, CO, ID, KS, LA, ME, MN, MT, NB, NM, OR, RI, TN, TX, UT, VA	State "wild card" statutes

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STATEMENT OF THE

AMERICAN BANKERS ASSOCIATION

BEFORE THE

SENATE COMMITTEE ON

BANKING, HOUSING, AND URBAN AFFAIRS

ON THE

ROLE OF THE FEDERAL RESERVE IN

PROVIDING PAYMENTS MECHANISM SERVICES

October 11, 1977

Mr. Chairman and members of the Committee, I am Charles F. Haywood, Professor of Economics at the University of Kentucky. I am appearing today on behalf of the American Bankers Association, and am accompanied by Thomas Rideout, Senior Vice President, Wachovia Bank & Trust Company, N. A., Winston-Salem, North Carolina and a member of the Executive Committee of the Correspondent Banking Division of the American Bankers Association. We welcome the opportunity to testify before your committee on the role of the Federal Reserve in providing payments mechanism services. The question was fundamental in the minds of policy makers when the Federal Reserve was originally set up, and is of continuing importance today, particularly in light of the development of new electronic forms of payments services.

The Provision of Payments Services by the Federal Reserve in its Capacity as the Nation's Central Bank

The provision of payments services is not a necessary function for the Federal Reserve in its capacity as the nation's central bank. The only neccessary function for the nation's central bank is the management of monetary policy. In today's economy, we can see no inherent reason why the provision of payments services must be exercised by the central bank in order to perform this function.

However, at the time of the founding of the Federal Reserve, it was deemed appropriate for it to perform a variety of payments services and it has traditionally done so. Before discussing the appropriateness of this role today, it will be useful to review some of the services provided by the Fed, and some of the historical factors which prompted it to provide payments services.

The Federal Reserve system augments the collection of checks on a nationwide basis through its unique branching network throughout the country. While the vast majority of checks are cleared by direct exchanges between banks, the Federal

Reserve provides a utility for interstate exchange not currently available in the private sector. It is useful to note, however, that many of the large banks have in recent years elected to bypass the Fed in favor of direct presentment of items even to far remote cities.

The Automated Clearing Houses operated in several cities by the Federal Reserve have allowed an orderly transition toward electronic funds transfer and benefited the American people by allowing the Treasury to speed payments and reduce costs of processing Treasury payments. The Fed has been instrumental in helping to develop this service.

The Fed WIRE, which allows the rapid transfer of funds from city to city, has been greatly enhanced in recent years. It allows major transfers of funds to occur quickly and safely outside the check collection system.

Through its Coin and Currency operations, the Federal Reserve provides the distribution networks for new cash from the Treasury into the hands of the American people and the collection system for worn and multilated currency.

One of the reasons the Federal Reserve was established was because the Congress perceived the public interest to be served by the establishment of a uniform national currency. In response to this concern, the Fed adopted a deliberate policy of attempting to eliminate non-par banking, the system whereby recepients of payments by check were charged fees for the privilege of depositing those checks in their bank accounts. For the most part, this effort was successful. Non-par banking was disliked because, at the time of the establishment of the Federal Reserve, our financial system had evolved to the point where checks were considered to be a substitute for currency. People felt that, if the value of a dollar used in a transaction was unrelated to the distance between transacting parties, the same should be true of a check. Also, there was a general belief that non-par banking encouraged an inefficient payments system, as checks tended to take very circuitous clearing routes in the attempt to avoid exchange fees. Problems of bank soundness were, in some cases, also associated with the high costs and inefficiencies of check clearing. The establishment of the Federal Reserve, with a system of required clearing balances for member banks, and the provision of free clearing services to them, did much to restore public confidence in the efficiency and soundness of our payments system. Thus, one of the reasons the Federal Reserve was established was because Congress perceived a role that was not being fulfilled by the private sector.

In today's world, however, there is an active and efficient payments mechanism provided by the private sector. While we would certainly not recommend that the Fed get out of the payments business entirely, it is not clear what the appropriate role for the Federal Reserve in the provision of payments services is. A complete withdrawal of the Fed from the payments business would be a wrenching experience for the banking system and should be done on a gradual basis, if at all. Nevertheless, we must note that more and more banks are finding Federal Reserve services less valuable relative to the reserves they must hold, and are withdrawing from the System. Surely this calls into question the appropriateness of the Federal Reserve in providing payments services today. Of course, one of the reasons Federal Reserve services are becoming less valuable to banks is the manner in which they are implicitly priced. Banks that are willing to bear the excessive burden of reserve requirements are given the services free. Other banks, generally, do not obtain services from the Fed at all. A second factor lessening the value of the Federal Reserve membership has been the innovativeness of the private sector in providing payments services. As the income lost from investment in non-interest bearing reserves has become more and more costly, the private sector has become more efficient in the provision of payments services and its market has expanded. In fact, some payments services, such as the bank card, have developed entirely in the private sector and have become very popular and cost-effective. This innovativeness in the private sector would also seem to call into question the appropriateness of the Federal Reserve's role in providing payments services.

In addition, we foresee several difficulties in pricing of existing Federal Reserve services and the provision of new ones. The problem of determining proper cost allocations is bad enough for regulators of private firms. For the Federal Reserve with its unique monopoly power to create money and its responsibility for administering monetary policy, the situation would seem nearly impossible. How does one allocate overhead costs among such diverse activities as the administration of monetary policy through open market operations, the provision of services as fiscal agent for the Federal Government, the supervision of state-chartered member banks, the regulation of bank holding company activities, and the provision of payments services which also can be provided by private banks? Even if all the relevant data were known, we can think of no way to do this on a rational basis. Indeed, as new payments systems evolves, it becomes more and more difficult to even know the relevant data. And the relevant data must be known if Federal Reserve involvement in a particular activity is to be justified on the basis that the private sector is not providing adequate service.

It is for this reason that the American Bankers Association suggested to the National Commission on Electronic Funds Transfer, that in EFT areas where new payments services are developing rapidly, -- automated clearinghouses might be an example of this -- if Fed involvement is appropriate the service should be priced on the basis of what the private sector would charge if it provided the service. Even this rule is difficult to implement on a fair basis since vendors of payments services in the private sector will frequently be charging different prices and operate under different cost conditions. This policy was proposed because of the belief that in some EFT areas there may be a "demonstration value" to having the Fed provide a particular service, with the private sector taking over the function after the value of the service is realized and known by all. This may have been the case with check clearing at the time the Fed was established. There seems to have been a clear need to demonstrate the value of par banking. However, with the increasing sophistication of correspondent banks, and the advent of deposit insurance, many of the inefficiencies and riskiness have been removed from payments activities.

The provision of payments services is the main banking area in which the Fed competes directly with the private banking system. Yet with 12 regional banks, each having several branches which serve primarily as operations centers, the Fed already has a nationwide system of operations centers in place. There is no way a single bank can be said to match this capability under the current banking structure. This makes accurate comparisons of the public and private clearing systems even more tenuous.

Another example of the difficulties of explicitly pricing Federal Reserve services was highlighted during recent consideration of S. 2055, proposed legislation dealing with NOW accounts and the burden of Federal Reserve membership. In discussion of this legislation, the Federal Reserve seemed to justify discrimination against larger banks in the payment of interest on reserves on the grounds that these banks took greater advantage of "free" Federal Reserve services. Yet, surely there are volume efficiencies in the provision of many payments services. Would the Fed propose to give volume discounts? Explicit pricing would seem to suggest such a policy.

In sum we believe a thorough investigation of the role of the Federal Reserve in the provision of payments services is certainly appropriate at this time. However, the proper roles for the public and private sectors cannot be determined by merely saying they should compete on an equal basis.

Access to the Federal Reserve's Services

If there is a proper role for the Federal Reserve in the provision of payments services it would, at first, seem logical that such services should be provided to all institutions. Unfortunately, we cannot agree with this approach at this time. When the Federal Reserve was originally set up thrift institutions were not in the payments business, and it was widely anticipated that all banks would eventually join the Fed. Of course, a significant portion of the banking system did not join the Fed, and in recent years other institutions have been getting into the payments system. The provision of payments services by the Fed is largely financed by the income derived from the use of reserves that must be held by member banks. These reserve requirements operate as a discriminatory tax. If payments services were provided to all institutions, reserve requirements would become even more discriminatory. Until something is done about the excessive burden of reserve requirements, only member banks should have direct access to Federal Reserve services.

Costs and Benefits of the Pricing of Federal Reserve Services

Two objectives frequently mentioned for the pricing of Federal Reserve services are economic efficiency and the development of technologically efficient payments systems.

Federal Reserve involvement in the payments systems has been justified by some on the grounds that there is, in some sense, a failure in the private marketplace. Payments services have been perceived by some as having economies of scale which cannot be realized in the private marketplace and should not be priced on a full cost basis, but only according to the marginal cost of producing one extra unit. Alternatively, it has been suggested that payments services might involve a public good which has such widespread benefits that they should be offered for free.

While we are skeptical of the accuracy of these views, it is useful to examine the implications of these methods of pricing. We have already mentioned the problem of cost allocations in a diverse public institution such as a central bank, and the difficulties in knowing the relevant data when technology is changing rapidly. There is an additional problem in that neither of these pricing methods would generate enough revenues to cover the cost of producing the service. Payments system activities would have to be subsidized relative to other economic activities. Also, such a pricing method would discourage private competition. For these reasons, it is our belief that when the relevant data are difficult to know any new venture by the Federal Reserve into the payments system area should only be on a basis that does not discourage private competition. Surely, when no one knows the form the future payments system will take, this is the best rule. Even with such a rule, we believe the burden of proof should be on the Federal Reserve to demonstrate the failure of the private payments systems before it undertakes any new activities.

Another potential objective in the pricing of Federal Reserve services is the development of technologically efficient payments systems. The development of some EFT applications may be extremely risky for private concerns to undertake. Nevertheless; some of the applications may increase the efficiency of the payments systems and the Fed may want to provide such services on a temporary basis. Under these circumstances, pricing of these services may be based more on considerations of the temporary nature of the Federal Reserve's participation in the market than on considerations of short run economic efficiency. A high price will forestall use of these EFT services and delay their development. A low price will accelerate use and acceptance of the services, but delay development of private EFT systems. One potential approach in this situation is the method suggested previously. That is, charge what the private sector would charge if it were offering the service.

How do these approaches to pricing compare with the current pricing methods used by the Federal Reserve? From the standpoint of an individual member bank -- the Federal Reserve sets a direct price of zero on services provided and then imposes a tax on it. The size of the tax is based on the deposits of member banks and substantially exceeds the cost to the Federal Reserve of providing the service. This method of pricing has resulted in at least one and possibly two distortions. The first distortion is caused by setting the price of access to Federal Reserve services above either the average or marginal cost of producing them. This results in a smaller than optimal number of banks making use of these services. This is currently being discussed as "the Federal Reserve's membership problem". Setting the direct cost of these services equal to zero for member banks may create a second distortion. Some member banks may use an excessive amount of the services from an efficiency standpoint.

Direct pricing of Federal Reserve services alone will only eliminate the second distortion. Any approach to direct pricing must include a significant reduction of the high price in terms of reserve requirements which banks must pay to gain access to Federal Reserve services. This could be accomplished by a reduction in reserve requirements, payment of interest on required reserves, or allowing certain types of earnings assets to qualify as reserve assets.

At one time the Federal Reserve put out for comment proposed changes in Regulation J which called for explicit pricing of services and credits against these prices for reserves held. Such a pricing scheme is anti-competitive in that it reinforces the incentive member banks have to use only those services provided by the Fed, and neglect private market alternatives. Our comments to this proposed regulation are attached to our statement and discuss this in further detail. In addition, this proposed regulation illustrates very well the temptation that exists to use explicit pricing as a tool to stem the erosion of Federal Reserve membership. If this were to happen, the broader questions of economic efficiency and an efficient payments systems could easily become hostage to the membership question.

Impact of the Federal Reserves' Current Role in the Payments Mechanism on Correspondent Banking

The current Fed policy in providing payments services is to charge a high admission fee, but to charge nothing per unit once access is established. In essence, the Fed currently is financing its payments mechanism by a tax on member banks in the form of required reserves.

The situation encourages the formulation of correspondent relationships to spread the high cost of initial access to the services; member banks shift their burden of cost to non-members by charging an implicit fee for Fed services to which they, as members, have unlimited access. While this aspect of current Fed pricing tends to encourage the volume of correspondent relationships, the zero unit price for use of services for member banks has inhibited the development of payments sytems in the private sector. Thus, the current structure of access to Fed services has a sharp impact on the nature of private correspondent activities; member banks are encouraged to act as conduits through which non-members can make use of the Fed clearing facilities.

To assess the impact of the Fed's current role on the development of correspondent services, it is necessary to have a point of reference. If the Fed's services were priced at zero with unlimited access for all financial institutions, there would be no incentive for the private sector to compete in the payments systems market. This conclusion is also valid if the Fed employs marginal cost pricing, with the operating losses being off set by a direct or indirect tax subsidy. If the deficit is financed by a one-time fixed entrance fee for the use of the services with the per unit charged based on marginal costs, the system would be similar to the current one. Correspondent relationships would be encouraged in order to share the expense of the cost of entry -- but the per item charge would tend to encourage participants to economize on the use of the service.

Pricing on the basis of what it would cost banks to provide the services would provide a healthly competition from the private sector. However, individual banks may still be at a disadvantage in competing in this market, due to the fact that the Fed has a nationwide presence which no single bank can match. Individual banks must form joint ventures to match this presence.

In sum, Mr. Chairman, we are skeptical that enough information is known so that the Federal Reserve can adequately venture into new payments system areas without inhibiting healthy competition. If it does, the standard of pricing should not be any direct measurement of Federal Reserve operations, but the cost to the private banking industry of providing a similar service. The burden of proof should be put on the Federal Reserve to demonstrate the widespread public benefits or economic efficiencies that justify an expanded role for the Fed in the payments systems area. We doubt that such benefits exist. The "issue" of access to Federal Reserve services exists because of the discriminatory tax placed on member banks in the form of excessively high reserve requirements. The Federal Reserve's membership problem must be dealt with first, before consideration is given to direct access by non-member banks and non-bank depository institutions.

EXECUTIVE DIRECTOR
GOVERNMENT RELATIONS

Gerald M. Lowrie
202/467-4097

4 November 1977

The Honorable Richard G. Lugar
United States Senate
5107 Dirksen Senate Office Building
Washington, D. C. 20510

Dear Senator Lugar:

On October 11, 1977, at the oversight hearing on the role of the Federal Reserve in providing payments mechanism services, you posed a question to Dr. Charles Haywood, who was testifying on our behalf, about the extent to which required reserve ratios might be reduced for Federal Reserve member banks without impairing the effectiveness of Federal Reserve monetary policy. We are pleased to have this opportunity to respond for the record.

The American Bankers Association has long supported the view that required reserve ratios of Federal Reserve member banks should be reduced. In 1957 the Economic Policy Commission of the American Bankers Association published a study entitled, Member Bank Reserve Requirements. The key conclusions of that study were as follows:

1. "That the chief function of reserve requirements is to serve as a fulcrum for the use of the discount rate and open-market operations in influencing the volume of bank credit and money."

2. "That the present high requirements should be substantially reduced over the years ahead to enable the banking system to accommodate the monetary and credit needs of a growing economy."

3. "That when reserve reform is undertaken, we should move in the direction of a geographically uniform system of reserve percentages."

4. "That vault cash should be treated as a reserve asset."

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Beginning December 1, 1959, member banks were permitted to count a portion of their vault cash to meet reserve requirements, and since November 23, 1960, all vault cash has been included in the legally required balances. At the end of 1976, vault cash accounted for $8.6 billion of the $35.5 billion total of member-bank required reserves. As banks must hold a certain amount of vault cash regardless of the level of legal reserve ratios, inclusion of vault cash as a reserve asset has made the burden of reserve requirements less than it would otherwise have been.

Prior to July 18, 1962, there were three categories of member banks with differential required reserve ratios. The categories were central reserve city banks, reserve city banks, and country banks. The first two categories were merged in 1962. Since November 1972 the Federal Reserve has not formally employed the reserve city and country bank terminology. Instead, differential reserve ratios have been imposed by size of bank and, additionally in the case of time deposits, by certain maturity designations. However, the size categories used by the Federal Reserve for demand deposit reserves are closely related to the old reserve city and country bank classifications of banks. A "geographically uniform system of reserve percentages," as recommended by the Association in 1957 has yet to be established in fact, though the present system does not explicitly differentiate by geographical location.

We also wish to note that when the Association's study was published in 1957 required reserve ratios on demand deposits were 20 per cent for central reserve city banks, 18 per cent for reserve city banks, and 12 per cent for country banks; the required reserve ratio on savings and time deposits for all member banks was 5 per cent. Currently, required reserve ratios for demand deposits vary between 7 per cent and 16.25 per cent depending on the amount of demand deposits held by the bank. For savings and time accounts, they vary between 1 per cent and 6 per cent depending on the amount of time and savings accounts held, the type of account, and maturity of account. Comparison with 1957 ratios is difficult, but in general there has been some modest decrease in average reserve ratios.

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This modest decrease in the level of reserve requirements, has not hindered the ability of the Federal Reserve to conduct an adequate monetary policy. Indeed, as you know, the Federal Reserve recently endorsed provisions of S.2055, which called for reduction in the statutory minimum required reserve ratios. Evidently, the Federal Reserve feels there is room for further reduction in required reserve ratios without any undue hindrance to monetary policy.

We have noted these changes since our 1957 study to demonstrate that dialogue with the Federal Reserve has resulted in improvements in the structure of reserve requirements. Regrettably, progress has not been sufficient to mitigate the burden of reserve requirements to the extent needed. It appears that the Federal Reserve now has a fuller appreciation of the need to reduce the burden of reserve requirements. Continuing dialogue might well be productive of further change. The door to such change could be opened by a simple technical amendment eliminating the statutory minimums for required reserve ratios.

Under 12 USC 462, the minimum required ratios on demand deposits are 10 per cent for reserve city banks and 7 per cent for country banks; the minimum for savings and time accounts is 3 per cent. Eliminating the statutory minimums would increase the discretionary authority of the Federal Reserve to make its own determination of the level of reserves consistent with the need to mitigate the burden of Federal Reserve membership as well as the need to assure efficient implementation of monetary policy.

We mention the possibility of eliminating the statutory minimums as one alternative that might be considered. We do not propose it at this time as an official position. However, we do favor reduction of reserve requirements. Expansion of the Federal Reserve's discretionary authority in this regard would also be consistent with the Association's long-standing position in support of the independent status of the Federal Reserve.

As to the extent to which required reserve balances might be reduced, we think that there is a rationale for reducing such balances by at least $10.5 billion. At the end of 1957 the gold certificate reserve of the Federal Reserve Banks was approximately $22.1 billion. The gold certificate reserve at

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the end of 1976 was $11.6 billion. The decline in the gold certificate reserve was associated, of course, with an outflow of gold from the United States in the late 1950s and the 1960s. This loss tended to decrease member-bank reserve balances. However, the effect on reserve balances was offset by Federal Reserve purchases of U. S. Government securities in the open market. The Federal Reserve thus gained interest-bearing assets in replacement of the non-income gold certificates. The interest-bearing assets were shifted from the private sector, mainly the banking system, into the Federal Reserve.

An alternative would have been for the Federal Reserve to reduce required reserve ratios commensurate with the decline in the gold certificate reserve. Dr. Haywood, who represented the American Bankers Association at the October 11, 1977 hearings, recommended such an approach to reduction in reserve requirements in the early 1960s. A gradual reduction in reserve ratios would have been possible during the 1960s. Required reserve balances today would be about $10.5 billion less than they are, and the Federal Reserve would be holding $10.5 billion less in U. S. Government securities.

We estimate that the Federal Reserve's income would have been reduced by about $687 million in 1976 if it had held $10.5 billion less in securities. The Federal Reserve's net earnings in 1976 were $5,982 million, of which $5,870 million were paid to the Treasury. A reduction of $687 million in the Federal Reserve's income would not be matched dollar-for-dollar by a reduction in the Treasury's income. Transfer of $687 million from the Federal Reserve to the private sector would result in some increase in Treasury tax revenues, as much as $330 million, or perhaps, even more. Net loss to the Treasury would be in the range of $300 million to $400 million.

In fact, there is no need for the Treasury to sustain any loss in revenue. It would be possible for the Federal Reserve to phase in a reduction in reserve requirements over a period of several years or so in such a way that <u>growth</u> in Federal Reserve net earnings would be slowed but the <u>level</u> of such earnings and payments to the Treasury would not be reduced. The following data on Federal Reserve earnings paid to the Treasury indicate a growth trend that could accommodate a phased reduction in reserve requirements without decreasing payments to the Treasury.

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<u>Federal Payments to the Treasury</u>
(millions)

1957	$ 542.7
1962	799.4
1967	1,907.5
1972	3,231.3
1976	5,870.5

Of course, a gradual phase in of the reduction in reserve requirements would mean that it would take a longer time to achieve an effective reduction in the burden of Federal Reserve membership.

There is disagreement both within and outside of the banking industry on the role played by reserve requirements in the administration of monetary policy. Nevertheless, even if reserve requirements are important as a supplement to open market operations in the administration of monetary policy, a statutorily specified minimum reserve requirement is irrelevant for this purpose. What is important is not the level of reserve requirements, but the ability of the Federal Reserve to <u>change</u> the amount of required reserves at a given point in time if monetary and credit conditions warrant such a change. In this context, elimination of the statutorily specified minimum reserve requirements would give the Federal Reserve sufficient latitude to significantly reduce its membership burden while still retaining the flexibility needed to administer monetary policy.

In closing, we wish to repeat that our long-standing position has been that reduction of reserve requirements is desirable. The extent of such reductions should be left to the discretion of the Federal Reserve. Legislative action should focus on the mitigation of statutory restrictions on the Federal Reserve's discretion, such as reduction, or perhaps elimination, of the statutory minimums for required reserve ratios.

Sincerely,

Gerald Lowrie

Gerald M. Lowrie

GML:mfc

Outline of Project to Estimate the Impact
of the Pricing of Federal Reserve Services

I. Purpose - To develop alternative scenarios for the pricing of Federal Reserve services and estimate their impact on the Banking industry.

II. Parameters of the pricing process

A. Services to be priced. ABA task force says that all Fed services should be priced. These would include such things as:

1. Check collection services

2. Automated clearinghouse services

3. Wire transfer services

4. Coin and currency services

5. Net settlement services

6. Securities safekeeping services

7. Bank examinations

8. Services provided to other governmental agencies

9. Any new services provided

B. Factors to be considered in determining prices:

1. What is to be done about membership burden

a. Interest on reserves

b. Reduction in reserve requirements

c. Government securities held as reserves

d. Nothing done to relieve membership burden

2. Cost factors

a. Cost concept used

(1) Fully allocated Federal Reserve costs, including cost of capital and taxes

(2) Something less than fully allocated Fed cost

(a) Marginal cost

(b) Average operating cost, no allocation of overhead

(3) Costs that would be incurred by the private sector if they performed the service

(4) Costs are ignored, membership burden is relieved by one of the methods stated above, and prices are set so as to have zero gain, or loss, to Treasury

b. Other cost distinctions

(1) Fed district

(a) Uniform price schedules in all Fed districts

(b) Price schedules depend on operating costs of Fed district

(2) Usage of services

(a) Volume discounts

(b) No volume discounts

(c) Others--e.g., are there economies in the joint usage of particular services?

(3) Geographic location of bank

(a) Prices uniform across country or, at least, within Federal Reserve District.

(b) Prices vary according to the location of the bank

3. Other dimensions of pricing problem

a. Access

(1) Priced services available to all depository institutions

(2) Priced services available only to member banks

(3) Current access rules are maintained/i.e., services which are currently provided to non-members will be provided to them under a pricing regime. No new services will be provided to non-members.

b. Availability - i.e., how quickly is the service provided

c. Others?

III. Factors affecting bank structure

A. Ability of correspondents to pass on added costs to respondents.

B. Responses of respondent banks to the added costs that are passed on.

C. Extent to which measures taken to relieve membership burden would offset added charges and negate the need correspondent banks would feel to pass on added costs.

D. Extent to which private sector will develop new payments systems outside the Fed.

E. Responses of member and non-member banks to the development of such systems. How would these responses affect the membership question?

IV. What is to be done?

A. A matrix of prices is to be developed. The matrix should show the prices for the services listed in part IIA under the different pricing scenarios that could be delineated using the factors listed in IIB.

> Note: We understand that some of the data needed to develop the cost estimates will be internal Fed data that we do not have access to. However, a fair amount of cost data is published by the Fed. It will be the responsibility of the consultant to use this data in conjunction with other available data to develop the best possible <u>estimate</u> of the costs.

B. The effect of each of the pricing scenarios on bank structure is to be evaluated. Some possible factors to be considered are listed in part III. The consultant may suggest other factors.

The CHAIRMAN. Thank you very much.

Let me start out with a question to you, Mr. Perkins.

You oppose the idea of a discount rate that is tied to some other rate, like the Treasury bill rate, as contained in the amendments before us, saying in your testimony that that is inflexible.

What is your basis for saying that? The Fed would, in my judgment and I am sure in yours, continue to have complete control over the discount window, could open or close it as it deemed necessary.

Mr. PERKINS. That is true, and I think you can make a very cogent argument that a market rate, an audit market rate on the discount rate, which is what the proposal is, would be fairly smooth, and would be in some ways something that might be attractive.

Our opposition is on the basis that the discount rate changes are about the oldest tool in the monetary policy kit. They are widely understood everywhere as a signal and they can be important as a signal in certain times.

I pointed out that the last time it was used that way was quite recently when the exchange markets were under such terrible pressure. It can calm the market at a time when the pressures were culminating in a very bad fashion.

I would say, however, that the other side and more practical side was the point I tried to make, in a period of recession or coming recession when the Fed wants to ease money, the best way to do it or a very easy tool to use is by lowering the discount rate which leads the market and starts to force rates down before a market rate would do that.

The CHAIRMAN. On this question of the signal, the reading of tea leaves, the burning of entrails or whatever it is, suppose this afternoon the Fed reduced the discount rate, I believe it is 7¼ percent now, suppose it reduced it to 7 percent.

What signal would this convey to John Perkins?

Mr. PERKINS. It would go a long way toward completely eliminating the thought, rates are going any higher as far as the Fed is concerned, at least that is their current estimate, and I think you would have a rather strong further rally in the bond markets and have a real impact on banks in turn.

The CHAIRMAN. Wouldn't there be other bankers of comparable stature who might say that "it doesn't mean a thing," that it simply indicates that the Treasury bill has recently fallen from 7.2 to 6.7 percent and the Fed is anxious not to be too far out of line from that?

Mr. PERKINS. I think that is an obvious interpretation. I am simply saying in the current climate, with some uncertainties to whether the conventional wisdom about rates going to get a little higher as the year goes on, is being questioned, and it would be interpreted, I think, the way I said first.

The CHAIRMAN. I thank you, and I am going to excuse myself for just a second and recognize Mr. Hanley.

Mr. HANLEY. I will address this question to Chairman LeMaistre.

In his testimony before this committee some days ago Mr. Campbell, a representative of the Independent Bankers Association, didn't exactly view this pending legislation with great enthusiasm. Certainly, his observation has to be taken under consideration.

So I ask, is it not desirable for this committee to report out a bill which takes care of the important problems associated with membership, monetary control, the competitive squeeze on smaller banks, and the efficiency of the payments mechanism, whether or not these goals are achieved by enhancing membership in the Federal Reserve System?

Now, if you agree that this is the case, could you discuss which of the proposed bills most effectively would accomplish this goal?

Chairman LeMaistre. Let me say first that I do think that the membership problem of the Fed is perceived by them as being a serious threat to their independence. It seems to me that perhaps a great deal of consideration should be given to that. But I don't think that the membership problem is necessarily tied to the implementation of monetary policy.

Now, as to the issue of equity among banks, certainly I think the Congress should be interested in seeing that they all compete on equal terms. And to me it seems only logical that the Fed be allowed to pay interest on these sterile reserves, which are the largest part of the burden of Federal Reserve membership, or that those reserves be kept in some kind of interest bearing security.

Now, I notice that in one of the bills there is a provision for a Federal Reserve study of the effect of investing the reserves in securities, and I think that is good.

I think that should be encouraged because it seems to me that if some return on these funds which are now earning nothing could be achieved, either by direct payment by the Fed or by permitting investment of reserves in securities, then we would move toward a situation where the banks would begin to compete in a more open, free atmosphere, because I think the next step would be to remove the prohibition on the payment of interest on demand deposits, and the present prohibition against paying more than a certain amount on savings accounts.

It seems to me these are all restrictions on the private enterprise system that ought to be removed if and when they can. And I think the Congress is properly giving serious thought to these. If it appears from our statement that we are opposing everything, we are not.

What we are saying is that perhaps it can be done a little better; the thrust of these bills is good.

Mr. Hanley. Would it be accurate to say that of the bills pending before this committee, as of this date, the one that would come closest to accomplishing the end goal, perhaps, would be the Stanton bill as amended by Mr. Reuss?

Chairman LeMaistre. In what regard, Mr. Hanley?

Mr. Hanley. The overall; of the number of bills we are considering, and certainly the Stanton bill as amended by Mr. Reuss is not the entire answer to the question, but as of this time would you say that it is a reasonably good approach to the elimination or at minimum the alleviation of the problem?

Chairman LeMaistre. I think that it certainly is a step in that direction.

The difficulty seems to me to be that if whatever means is used brings about universal membership, then what happens to the State systems? There is, as Mr. Leonard pointed out, a great threat to the viability of a

State supervisory system if all of its members—all of its components—become members of the Federal Reserve System.

I think that there is a great deal to be achieved in our dual banking system by preserving just that factor that in the past has encouraged innovation, such as the experiments that we now see in New England and other places.

I think that these have been good for banking, and I would not like to see us put all of the institutions in a single line of march where they all did exactly the same thing all of the time under the same authority.

It seems to me that if we destroy the dual banking system or damage it, that we are taking a great risk of doing just that.

Mr. HANLEY. I guess what I was attempting to establish is this:

Are we fundamentally on the right track with the vehicle that I have already alluded to? Certainly there will be changes in that measure and you gentlemen this morning have made some very interesting comments. I know I have picked up a number of ideas already whereas we might improve upon that basic vehicle that we are working with.

What I am attempting to determine is if, in your judgment, this is a reasonable approach. I think that I can draw a conclusion from what you said that in all probability it is a reasonable approach at this time.

Chairman LEMAISTRE. I think so.

Mr. HANLEY. Thank you.

Mr. Wicks, I think your bank is a classic example of the problem and, as you said in your testimony, that was a very difficult decision. You were patient, having considered that possibility back in 1973, and then really delayed action on it for this 5-year period in the hope that something would occur legislatively or otherwise that would relieve you of that problem, and your position then would have you remaining as a member of the Fed.

First Trust & Deposit Co. is a part of a holding company in which some of the banks have remained as Federal Reserve members. Is it not true that all but one bank of a holding company may leave the Federal Reserve and still enjoy Federal Reserve services without being subject to the Federal Reserve requirements?

Will you please tell us which of the bills before us today, in your judgment, would effectively solve the problem?

Mr. WICKS. Yes; we are a member of a holding company, and the largest bank in the holding company remains a member of the Federal Reserve System. This is of some aid. However, I don't believe that this is the only reason why we would get out of the Federal Reserve, or any bank would. I think any bank could get the same services from a correspondent bank as they could get from a bank in the holding company.

Also, I don't believe, but I might have to ask some of the panel members here, I don't think there is any law that says one bank must stay in the holding company.

If they were all State-chartered banks, I believe all banks in the holding company could withdraw from the Fed and I do think we could get pretty much the same advantages we are getting today by using correspondent banks rather than the bank holding company banks.

I believe that the principles that are discussed here in these bills are the ways in which we should be thinking. I think it is a matter of the approach to it as to whether or not we are ready to have the Federal Reserve System pay competitive rates for the sterile reserves that are kept there. If the rates are not competitive with correspondent banks, I would see no reason why State banks would stay in the Fed or go back into the Fed.

You were discussing the Stanton bill with the revisions of Chairman Reuss. As I look at that, I would say, if I understand the amendments, that this would not provide enough income for the banks or enough interest to pay on those deposits to keep banks in the Federal Reserve System. As I understand it, and we would only use the amount that was charged for services plus the amount that would be earned through the discount window, and the figures that I have seen would indicate that that would not be sufficient to have us go back into the Federal Reserve System.

I would think this would be true of most State-chartered banks that are not members, that they would not see any advantage in going back in.

I also believe it is true of the charges that would be made for services. I think they do have to be competitive with the correspondent banks and if they are not I think there is a free market out there, if it is not competitive, again, I think the banks would go to the correspondents for their services.

Mr. HANLEY. I appreciate that response and I interpret you again as saying that this is not the all perfect vehicle for the reason you just mentioned but, essentially, it is a pretty good start here.

Mr. WICKS. I think the principles that are in these bills are certainly the direction that we should be thinking about, yes.

Mr. HANLEY. Thank you, Mr. Wicks.

Now, I defer to the author of the bill and ranking minority member of the committee, friend and colleague, Congressman J. William Stanton.

Mr. STANTON. Thanks very much, Mr. Hanley.

Gentlemen, let me express my personal thanks to all of you for coming, and some of you from quite far distances, in order to enlighten us.

The more we have delved into this subject matter, I can tell you, the more we realize that other Congresses have gone down this route quite a few times in the past, and perhaps even we have gone a little bit farther than they have in getting to this point. But, it is something that we want to address and, hopefully, if there is a solution, to try to find it.

My first question to all of the panel would be concerning Mr. Leonard's statement, on page 4, he stated that a reduction of 1 percentage point in reserve requirements for certain member banks would largely solve the equitable treatment problem.

Of course, what the hearings got started on and what we wish to address ourselves to is the loss of membership by members of the Federal Reserve System. Immediately you come to the fact the one existing problem is the inequity between members and nonmembers and why it has become very obvious so many members are leaving the Fed.

But, I would be interested from the panelists to know, do you all agree with Mr. Leonard that a reduction basically of 1 percentage point in reserve requirements for certain member banks would largely solve the equitable treatment problem? Could I hear from all of you on that subject?

Mr. Wicks?

Mr. WICKS. Yes; if you want to start at this end.

Mr. STANTON. Sure.

Mr. WICKS. I frankly don't think 1 percentage point would cause us to change our feeling about Fed membership. I don't think that would be sufficient of a reduction of our costs to cause us to go back into the Fed, and I think that would be indicative of other banks in our position.

Frankly, I think as long as we can get greater income outside, I think it is our obligation to find the best income we can as presidents of banks.

Mr. STANTON. Before I continue down the panel, Mr. Wicks, you are sort of very special because you have had this experience of withdrawal. What kind of incentive would you need to go back in?

Mr. WICKS. To go back in? If we could receive the services that we can get from correspondent banks and the income that we can get by investing the funds that we have available, if we get the same income we would certainly go back into the Fed because we would like to be members of the Fed.

There is no reason for us to withdraw except for that purpose, and it seems to me it is a very simple thing as far as our judgment is concerned as to whether we would go back or not. It is simply whether or not we could end up as well on the bottom line.

Mr. STANTON. Who is next?

Mr. LEONARD. Mr. Stanton, there are various reasons why a bank might withdraw from the Fed over and above, and different from the reserve requirement issue. Sometimes that gets to be the straw that breaks the camel's back, so to speak. But services they receive versus services they can receive from a correspondent, and so forth, all have an influence on them. Reducing reserves by 1 percentage point would just lessen the weight of that straw that might break the camel's back.

Mr. STANTON. It would be a combination of factors then?

Mr. LEONARD. It would just lessen that factor significantly enough probably, and this plus other factors would overcome their objections, resulting in a decision to stay in the Fed.

I think Mr. Wicks' bank is a little bit of an exception. I think you will find that most of the banks that withdraw from the Federal Reserve System are not $500 million banks. Also, in Mr. Wicks' case I understand that his bank is not engaged in correspondent banking whatsoever, and most banks weigh the economic factors.

The banks that are in the Fed today are not in the Fed because they love the Fed; they are in the Fed because it is profitable for them to be in the Fed irregardless of reserve requirements.

Mr. STANTON. Chairman LeMaistre?

Chairman LEMAISTRE. I would have to say that I think the decision made by most of the banks that have left the Fed is based simply on economic reality. For them, it costs less to be outside than it does to be on the inside. But as far as the need for membership is concerned, I am not persuaded that the Fed needs members to conduct monetary policy.

I think there are other reasons for requiring membership in the Fed, such as that it should be an independent agency or that it should have a constituency that can give it some strength within the Government. But I don't subscribe to the view that membership is essential to conducting an effective monetary policy.

So I would say that the banks themselves are making a simple business decision: Can I have a better year? Will the bottom line look better if I am not in this organization than it will if I remain in?

I don't think the individual bank should be required to become a member to its own detriment or for the purpose of implementing monetary policy.

Mr. PERKINS. I guess I would not disagree with Mr. Leonard that there are a lot of factors in any decision of the type of whether or not to be in the Fed. But, in our experience with many, many banks, clearly the determining factor is the cost of keeping the required reserves, and in my judgment, the 1 percentage point would not make any difference.

But I would like to ask my associate here, Mr. Olsen, on that point.

Mr. OLSEN. Thank you. Unless I misunderstand the suggestion, I would just change one small word, a reduction "to" 1 percent rather than "of" 1 percent would effectively solve the membership burden.

May I also add while I have this opportunity that the original bill that you submitted without the amendments represents today, in my opinion, the best solution that we have before us here.

Mr. STANTON. I am glad to hear that. I will say in return I did read your testimony, too, before the Senate, in October of 1977, so I do know how you feel on that subject.

Mr. OLSEN. Thank you.

Mr. STANTON. One last question.

Mr. Perkins, you spoke in your testimony on page 3 to the fact of the study that the ABA was undertaking in regards to reserve membership, the pricing of services and its effect on the structure of the banking industry.

Do you have any time schedule for completion of that study?

Mr. PERKINS. We discussed that last night because, obviously, you are trying to handle it now and we are talking about a study. The proposal or the answer on that is that it will be some time, particularly in this whole pricing question, before the Federal Reserve implements whatever regulations they propose.

In the meantime, we would expect this study to generate some factual data and to come in in parts. So that between now and the yearend we ought to have all of it, and most long before that. We can use this data as a part of the analysis of the Federal Reserve's proposals. They are proposing to come up with data, in just a few weeks, on the pricing issue.

Mr. STANTON. You did say you probably would have this study completed by the first of the year?

Mr. PERKINS. I think so; yes.

Mr. STANTON. Thank you very much.

The CHAIRMAN. Thank you, Mr. Stanton.

Mr. Derrick?

Mr. DERRICK. Thank you, Mr. Chairman.

Chairman LeMaistre, let us pursue this matter of monetary policy. I happen to be of the opinion that as far as this country is concerned, probably the greatest service the Federal Reserve renders is setting monetary policy. I realize that they act as an accounting agency and a bookkeeper and correspondent bank and so forth for banks, and I know that is important to the banking industry.

But, I think that the Fed agent acts as a very responsible tool, as an offset against the Congress in this capacity.

Now, the Chairman of the Federal Reserve, Mr. Miller, was before us last week, and he stated without any reservations that he thought it was necessary to have membership or participation in the Fed for him to effectively set monetary policy, and he went a step further, as I recall his testimony, and said that he felt he could be more effective if he had more membership.

Now, this apparently is not your opinion, and although you have discussed it a little bit this morning, I would like to go into it maybe a little deeper; but tell me, first of all, do you think that the Fed serves a useful purpose by setting monetary policy?

Chairman LEMAISTRE. Sure; I think it is the primary purpose.

Mr. DERRICK. I assume you did, but just for the purpose of the record. So my next question is, if you are not going to have Fed membership and participation, what tools would be available to the Fed to set monetary policy?

Chairman LEMAISTRE. Let me start off by saying I am not an economist.

Mr. DERRICK. I am not either, I assure you.

Chairman LEMAISTRE. And I have seen a number of studies on that very subject, and all of them come down to the final results that the need is information. The Fed needs statistics, it needs knowledge of what the aggregates are and that sort of thing, and that those things are useful to it or necessary to it in implementing monetary policy.

Now, you don't have to be a member to give information. So I say that the membership question is not really critical to monetary policy. Now, I am not saying membership is not important, however. I do agree with Mr. Miller that the Fed ought to maintain a substantial membership. But I have a different reason for thinking so.

Mr. DERRICK. Now, I don't suppose that you think that merely information is going to be sufficient. Surely if that were the case, we could have a much less sophisticated operation in the Federal Reserve System if all we had to do to set monetary policy was collect information.

As I see it, that is an important part of it, but the membership in the Fed and the participation in the Fed allow the implementation of that information. Of course, everyone in the Congress and business and so forth acts from a basic altruistic motive, but sometimes we need a little something to hold over their heads.

That, to me, is what the membership provides. You have probably done more research on it than I have, and I am aware that there are some economists that agree with you, but I don't think the Chairman of the Fed agrees with you.

Chairman LEMAISTRE. I don't know; I have never asked Chairman

Miller directly. But I did read his testimony and I gather he does not agree. I still say that the evidence adduced by all of these various studies indicates that information made available to the Fed to help them conduct open market operations is what is really needed.

Mr. DERRICK. We could really, I might suggest to you, transfer this bookkeeping and information gathering over to the FDIC and just do away with the Fed and let them go along; you would go along with that, wouldn't you?

I am being facetious; you don't have to answer that, Mr. Perkins.

Mr. PERKINS. I would really like to ask Mr. Olsen to answer that. He has devoted a great deal of his professional life in this area, and I think has read all of the literature and thought a great deal about it.

In general, I would agree with the basic position that Chairman LeMaistre espoused, but only in part, and I would like to let Mr. Olsen, answer it.

Mr. DERRICK. Let me say my great concern is, although Congress has great wisdom, I don't think they have the ability or that it would be in this country's best interest for the Congress to set monetary and fiscal policy. I don't want to do anything that is going to weaken the ability of the Fed to set this monetary policy.

Mr. OLSEN. Effectively, the question of membership and monetary policy are separate and I think that, in fact, if you trace back through the history of the Federal Reserve from its origin you will find that the question of membership was originally placed and considered for reasons other than the conduct of monetary policy.

In fact, the Federal Reserve monetary policy was sort of an evolution within the Federal Reserve after its original establishment.

There is no need for the Federal Reserve, to, in effect, have membership. The first question to ask is what constitutes membership?

It means that they keep reserves at the Fed, which has been discussed a great deal here, and the second is that they receive certain services from the Federal Reserve.

Now, the way in which monetary policy is conducted is through several devices:

The most important is through the conduct of what we call open market operations and this is how the Federal Reserve, in effect, puts reserves into the banking system.

Now, it would seem to imply as though the reserves flow uniformly immediately to all of the membership banks and/or from the member banks, and this is the reason why it is important to have a large network of the banks as members. However, the Federal Reserve conducts monetary policy by buying or selling government securities through a small group of approximately 20 that are recognized government security dealers, most of which are commercial banks.

So it is through that, on that fulcrum, in effect, that monetary policy is conducted through the open market operations in putting reserves into the banking system. So that the most important tool is not something which is dependent upon having a large membership represented.

Mr. DERRICK. Thank you.

My time is up, but let me just say surely you understand or give me credit for understanding that membership means just evidence of participation; what I am talking about is the participation in the Fed, and whether they have a membership or not is really beside the point.

I understand the workings of the Fed and thank you for your lesson.

The CHAIRMAN. Thank you, Mr. Derrick.

Judge Kelly?

Mr. KELLY. Thank you, Mr. Chairman.

Gentlemen, I want to apologize for being delayed in arriving here this morning and it may be the question I am going to ask has to some degree been covered.

But the Nation, the Federal Reserve, the world is in some peril because this committee is getting ready to do something. Now, is the situation with regard to the Fed such that what we are getting ready to do is justified?

Can we, can the Fed limp along with the degree of indigence it has, probably with more effectiveness, if we would do nothing? I don't think we will take the opportunity to do nothing. But on the out chance that we might, if doing what we are getting ready to do is not justified, I want to ask the question.

In other words, one of the questions is the loss of membership and so forth, and do you feel that probably the situation would be better without any action or do you think that we need to do what it appears we are about to do?

Chairman LEMAISTRE. First, let me say I don't think there is any simple answer to this question and, obviously, it has been coming up for so long before the Congress that I know the Congress doesn't look for a simplistic answer.

But I also have to say that something should be done. I don't think you should walk away from the problem. I am not convinced, however, that universal membership is the answer. I think the other proposals are much better. That is, permission to pay interest on the reserves which heretofore have been earning nothing and pricing the services which have been furnished free to members so that they will be available to all, and I even suggested maybe opening the discount window to more than Fed members—to all banks alike—would be helpful.

I think that the most hopeful of the proposals is to permit the Fed to reduce the burden of membership so that there is a reason for remaining in it or joining it, and not compelling everybody to become a member of the Federal Reserve System.

Mr. KELLY. Let me ask you this.

The Federal Reserve System has been in effect for how long, 50 years?

Chairman LEMAISTRE. Since 1914.

Mr. KELLY. All right. Then what has transpired in recent times that has caused this situation to become critical, because we have not passed any laws that created this, have we?

Chairman LEMAISTRE. I don't think it is due to legislation, no. I think it is due to the——

Mr. KELLY. Is it just general deterioration or has there been an abrupt change in circumstances or is this some sort of response to current political pressure or the news media or why are we doing this?

I mean, did we just suddenly discover that we have a problem after all of these years?

Chairman LEMAISTRE. No. This is not something new. It has been going on for a long time, for at least 10 years. The process of attrition has been going on. It has accelerated recently.

Mr. KELLY. Attrition in membership?

Chairman LEMAISTRE. Yes.

Mr. KELLY. Do you foresee in any of the suggestions that have been made as a solution that there is apt to be more harm done with the solution than living with the problem we have been living with?

Chairman LEMAISTRE. If the solution were to require universal posting of reserves by all banks, there would be an incentive to join the System. Since you had to put up the reserves, you might as well be a member. In that circumstance I think there might be a threat to the dual banking system, and a danger to the State supervisory systems.

Now, the other alternatives which have been proposed I think probably would help, and would result in checking this continued movement away from the Federal Reserve System.

Mr. KELLY. Could I just ask one question: Do you think high interest rates possibly have been an aggravation of this?

Chairman LEMAISTRE. Yes; to the extent that they increase the cost of doing business on the part of the bank. Anything that has raised its other costs has made them look closer at the burden of staying in the Fed and posting reserves which produce no income.

Mr. KELLY. Then are we, if in attempting a solution we are going to get some good things and some bad things, aren't we really trying to work at the wrong end of the horn, that high interest rates are caused by mismanagement of the economy, that is, Government management of the economy, because there was mention made about the wisdom of Congress here, and I think that the individual Members have great wisdom but they just simply are not using it in the solution of the Nation's problems.

We are in the process primarily of getting elected and responding to what is politically expedient, so it does not make any difference how smart we are if we are not using our smarts to solve the problem, so it does not make any difference.

What I am wondering is if really we are not trying to just patch up to avoid the results of mismanagement? I would like your comment on this.

Chairman LEMAISTRE. For whatever reason the difficulty has grown greater. I admit that. But I must say I don't think that that argues for an arbitrary fixing of interest rates.

It seems to me if the marketplace is in trouble the marketplace will correct its troubles, and the more we can allow competition without unwarranted interference, the better chance we will have of straightening the whole thing out.

So I would say the proposals move in the right direction in that they move toward freeing up the opportunities that the Fed has to retain membership, and also allow the banks to determine which of the services they want to buy or where they want to buy them.

Mr. HANLEY. The time of the gentleman has expired.
Mr. Gonzalez?
Mr. GONZALEZ. Thank you, Mr. Chairman.
I have two questions for Chairman LeMaistre.
The Federal Reserve has claimed that it needs regulatory supervision over and familiarity with the financial condition of banks that have access to the discount window.
First, under current practices, does the Federal Reserve have such knowledge in the case of national banks who are regulated by the Comptroller and, second, in the case of nonmember banks, in your opinion, would the intervention of FDIC in favor of a worthy bank in contemporary difficulty be sufficient to protect the Federal Reserve and the public from the dangers of ill-advised lending at the discount window?
Would you then recommend that we enact language to permit such an intervention as to be interpreted as sufficient showing that lending to a nonmember bank is in the public interest?
Chairman LEMAISTRE. The first part of your question—of course, the discount window is available to national banks. As to the availability of the discount window to nonmember banks, I think the law is so written that it can be made available. It has been interpreted, however, in such a way that, at least since 1966, there has been no activity in lending to nonmember banks at the discount window.
My suggestion is that some means be devised to make that service available to all banks, and the first and most obvious reason for that is that if a bank is in difficulty, in danger of failing, it is much less disruptive to work out some kind of purchase and assumption agreement so another bank assumes the liabilities and purchases the assets or those of them that it would like to have, or work out a merger or work out some orderly disposal of the problem.
To do that sometimes a loan is necessary. I remember at least one which I cite in the statement. The bank in Orangeburg, S.C., was not permitted to borrow at the discount window and FDIC made an advance of considerable size for that little bank to keep it going until we could arrange for its orderly disposal.
We knew at that moment it was insolvent. It was frozen, and it was necessary to keep something in place until we could work out the purchase and assumption by another bank.
That did work out in that particular case. It was an emergency, and it seems to me that that points up that if we as the insuring authority had been permitted to simply guarantee to the Fed that a discount window loan to that bank would be repaid, either by us as the insurer or by the bank itself, that we might have had a little less of a problem there.
The suggestion I make is that the discount window be opened to nonmembers upon certification by the FDIC that these circumstances exist, and that there is reason for propping up the bank for that much longer and accompanied by a guarantee.
Now, that might put the insurance fund at risk. But it would be a very rare case where you would not be able to recover that loan in the liquidation of a failed bank.
Mr. GONZALEZ. You don't see any jeopardy to the Federal Reserve

in that type of a situation of any vast extent or any great problem if we were to provide language to permit such things?

Chairman LEMAISTRE. I can't see any threat whatever to the Federal Reserve.

Mr. GONZALEZ. Thank you very much.

Mr. Perkins, I had one question maybe for the record because the chairman may indicate that we have to go register our vote.

But, in your testimony you state and I quote:

For the foreseeable future, a strong membership base will be very important to the conduct of monetary policy.

Now, I wonder if you could elaborate, if we don't have time now, for the record, on what in your opinion would constitute a strong membership base, what membership pattern would you like to see or suggest, and is there a percent of the total banking deposits that should be held in membership banks?

Is there a size or geographic distribution of member banks that should exist?

Mr. HANLEY. If the gentleman will yield, unfortunately we do have a vote on the floor, and if we may request that the question be answered in writing to Mr. Gonzalez we will appreciate that.

Mr. PERKINS. Certainly.

Mr. HANLEY. The hearing will stand in recess for 10 minutes.

[A short recess was taken.]

The CHAIRMAN. The committee will be in session again.

I believe Mrs. Fenwick was recognized.

Mrs. FENWICK. Yes.

I took down a few notes while you were testifying, and I understand your concern for the dual banking system and your fear that universal reserve requirements might hurt this dual banking system.

I wanted to ask you, who do you think should set the interest rates, the Federal agencies, Home Loan Bank Board and so on, all of them together, who should?

Chairman LEMAISTRE. You mean if you don't rely on the free market to set them?

Mrs. FENWICK. Would you just leave it to the free market?

Chairman LEMAISTRE. I would certainly say that the Federal Reserve could set its discount rates, but as nearly as we can, the free market forces ought to determine what the interest rates would be.

Mrs. FENWICK. But I am surprised that you say that the open market is the controlling element in the monetary supply.

Did I understand you correctly?

Chairman LEMAISTRE. I said it was the most dominant element, one that is most useful to the Fed.

Mrs. FENWICK. We heard testimony the other evening from a group of economists who all felt that the monetary supply was by far the most telling and important element in inflation, far more than interest rates.

Would that accord with your view?

Chairman LEMAISTRE. I don't disagree with that.

Mrs. FENWICK. But, if according to Mr. Leonard's testimony the State banks resent the Federal Reserve getting data, all of the data they want, how can the Federal Reserve operate effectively? On page 8, Mr. Leonard stated that the Fed should not have the unrestrained right to any and all data, and yet you say that the only way the Federal Reserve and the open market and the 20 banks working with the Federal Reserve can help in controlling money supply, is to have data. How are they going to do it?

If you have a relatively small membership, falling continually, if the components of the dual banking system have a right to withhold data and information the Federal Reserve asks for, how do you control the monetary supply?

Chairman LEMAISTRE. I am not sure they have the right to withhold information. I advocate that the greatest provision possible be made for furnishing all the statistics that the Federal Reserve needs.

Mrs. FENWICK. Should this be a requirement?

Chairman LEMAISTRE. It could well be. At the moment I say I don't think it is necessary because I think it is available to them anyway.

Mrs. FENWICK. Apparently the Fed should not have unrestrained right to any and all data it might request or in the form I might request it.

I can see there might be difficulties in the form, causing paperwork, but I don't see how the Federal Reserve can function at all if it has a diminished membership and if it has not the right to acquire data it needs in order to conduct sound monetary policy.

Mr. LEONARD. I did not mean the Fed could not have free access to the data they need for setting the monetary policy. However, I think in the request for data there should be some consideration given to the cost/benefit of that.

Mrs. FENWICK. What does that mean, cost/benefit?

Mr. LEONARD. If they are not going to do anything with the information when they get it and it costs the banks x hundreds of thousands of dollars, there is no reason to give the information in the first place. They should determine what they are going to do with the data other than fill up a room with paper. Certainly the Fed should have all the information they need for a sound monetary policy.

Mrs. FENWICK. How do you suggest that could be arranged except through the commonsense of the Federal Reserve Board?

Mr. LEONARD. I would hope the good commonsense of the Federal Reserve Board would prevail.

Mrs. FENWICK. I gather you feel it hasn't, if I understand correctly.

Do you approve, Chairman LeMaistre, of the interest on checking accounts, on the new movement in that direction? And also more importantly, I want to ask you something that has puzzled me.

If a higher rate of interest is allowed to the thrift institutions because of the social desirability of home building and homeowning, why have we reached a point where all banks are not allowed to enjoy the benefits which are open to the thrift institutions, if they meet the socially desirable proportion of mortgage loans, whatever that might be set to be?

Why have we gotten into this curious situation whereby a bank which has one name can do something and get certain tax arrangements denied to a bank with another name, doing precisely the same desirable social action, to precisely the same ratio or proportion, but unable to enjoy either the rate of interest or the tax benefits? How did we come to that?

Chairman LEMAISTRE. I would have to say the Congress takes part of the blame.

Mrs. FENWICK. Do you think we ought to get rid of it?

Chairman LEMAISTRE. Yes; I do. I think the differential should be removed and I think the limitation on the interest payments on savings should be removed because I think the value of money is something that can be determined. It is like determining what is the rent on a house. It is worth a certain amount, and it is wrong to say to the saver, "You may not have what your money is worth."

I think we should face up to the fact that some things have to be done before that will be a viable step. We have to do something about usury rates; we have to make sure we are not allowing a bank, or in effect letting the market require a bank, to pay more money than it can afford, but if you take off the limitations on the cost of loans—in other words, if it can charge what the market requires and pay what the market dictates, then it seems to me we would be in a much better position.

Mrs. FENWICK. We would have to have some usury laws though, would we not? Some controls so there wouldn't be enormous charges?

Chairman LEMAISTRE. I have no objection to usury laws, but I do think usury laws which set an unrealistically low rate are counterproductive. They do not furnish funds to the people who need them.

Mrs. FENWICK. It seems to me the whole banking institution, coming to it from the outside as I do, is somewhat irrational. It doesn't seem to follow any kind of commonsense pattern. We seem to have decided that it is a good thing to have housing and so we give certain banks certain privileges if they do have a large proportion of housing mortgages, but I understand that some of our thrift institutions have no set proportion of mortgages. Is that so?

Chairman LEMAISTRE. The idea of encouraging housing obviously is admirable. Nobody will quarrel with that. The question in my mind is whether what we have done has been effective, whether the thrift institutions have been able to meet the needs for housing, and whether they have been able particularly to meet it in times of high interest rates when there are other opportunities and funds cannot flow into that particular type of institution.

I think the Hunt Commission had a very sensible suggestion. If you want to encourage housing, why not give the instrument which finances the housing some benefit, no matter who gives the loan, whether a bank, insurance company, or thrift institution. If in fact the loan is made for a socially desirable purpose and the Government, in its wisdom, thinks that is to be encouraged, then let that instrument have some benefit, either a reduction in tax or something of that sort.

Mrs. FENWICK. Thank you very much. My time has expired.

The CHAIRMAN. Mr. Green.

Mr. GREEN. I would like to return to the question of the adequacy of the data on deposits from nonmember banks that Mrs. Fenwick raised.

Mr. Chairman, I would like unanimous consent to submit for the record an article from the July 10, 1978, Wall Street Journal, entitled "Fed Use of Incorrect Money Supply Data May Spur Economic Woes, Analysts Say."

The CHAIRMAN. Without objection, that will be received into the record.

[The article referred to by Mr. Green follows:]

(Wall Street Journal, July 10, 1978)

Fed Use of Incorrect Money Supply Data May Spur Economic Woes, Analysts Say

By EDWARD P. FOLDESSY
Staff Reporter of THE WALL STREET JOURNAL

NEW YORK—Inaccuracies in gathering and compiling information on the nation's money supply may be leading the Federal Reserve System astray in carrying out monetary policy and could result in an economic tailspin.

That, at least, is the view of a growing number of economists and analysts who closely monitor the Fed's activity and its impact on the economy.

The money supply is the total of private demand, or checking account, deposits plus cash in public hands. It has become an important consideration in recent years for Fed credit-policy decisions.

Because the supply reflects funds readily available for spending, it is considered an important determinant of economic activity by many economists. Too slow a growth, it's believed, will cause the economy to stagnate, but too fast a growth will do little except spur inflation.

The Fed's goal, therefore, has been to try to walk a narrow path between those extremes to lay the groundwork for a sustainable, balanced economic growth.

Poor Quality of Numbers

But walking that tightrope is becoming difficult, if not impossible, because of the relatively poor quality of money supply numbers, analysts say. In the past 1½ years, the money stock numbers have been almost consistently revised upward as more detailed information became available and absolute errors discovered, they note.

Throughout most of that period, the Federal Reserve had been operating under the assumption that money supply growth was slower than was actually the case. Thus, analysts say, the Fed supplied more money-creating reserves to the banking system than prudent.

"With the (upward) revisions of the money supply, the outlook for inflation and interest rates has worsened so much that the likelihood of a recession during the next 12 months has become substantially greater," warns Lawrence Kudlow, a vice president of Paine, Webber, Jackson & Curtis Inc.

David M. Jones, an economist for Aubrey G. Lanston & Co., notes that "the Fed in underestimating the money supply will tend to hold up on its credit tightening." Eventually, he reasons the Fed is "forced into more drastic tightening because it waited so long to apply the brakes in the first place."

At the hub of the problem is the fact that many banks aren't members of the Federal Reserve System and thus don't report figures to the Fed on a weekly basis. To obtain a money stock calculation, the Federal Reserve must estimate the amount of deposits at these nonmember banks.

The Fed has a fairly accurate measure of the deposits at these institutions only four times a year—when the banks file their quarterly information reports with the Federal Deposit Insurance Corp.

To estimate deposits at nonmember banks, the Fed looks at deposits at more than 5,000 small member banks. It compares those figures with the nonmember quarterly figures and calculates a ratio between the two groups. It then forecasts the ratio through the next quarter. The ratio is applied to the weekly 5,000 group to get an estimate of nonmember deposits.

Thus each quarter, the Federal Reserve revises the money supply numbers to reflect the new quarterly reports of nonmembers and recalculates the ratio.

Of the past six benchmark revisions, five have raised the money supply level from that originally estimated, while one reduced it. In addition, the Federal Reserve last month revised several weeks of numbers to correct a processing error.

Upward Revision

The latest quarterly benchmark revision took effect with figures covering the week ended June 14. Those revisions showed that the money stock had risen at an 8.1% clip over the previous 12 months, compared with an originally estimated 7.5% rate. The rise was especially significant because the Fed had previously stated that it couldn't tolerate a growth of more than 6½% over a long period. Thus, the revision simply compounded an already poor showing.

The May growth rate for the basic money supply, M1, has shown an even larger impact. Originally, the May growth was put at a 5.9% annual clip. The benchmark revision raised it to 6.9%. It was further boosted to 8% after a revision to correct a processing error.

"It tends to shake one's confidence in the figures," states William Griggs, a senior vice president of J. Henry Schroder Bank & Trust Co. "Maybe M1 isn't what we should be looking at." He suggests the Fed should be guiding policy by looking at "what's happening to bank credit, and what's happening to interest rates and the economy."

Paine-Webber's Mr. Kudlow suggests the Fed should do something about getting more accurate money supply numbers. "The Fed has to devise better ways to work with the FDIC and the state banking agencies to gather more deposit information," he says.

Nonmember banks represent a large part of the nation's deposits. Alan C. Lerner, a senior vice president of Bankers Trust Co., New York, estimates that about 30% of the nation's deposits are held by such institutions, up from only 15% several years ago. Part of the reason is that more and more banks are dropping out of the Fed to avoid stiff reserve requirements, money kept at the Fed to back the banks' deposits. In addition, many of these banks have been growing faster than member banks.

The Federal Reserve admits it has a problem in estimating the money supply. Says a spokesman, "It's something we'd like to improve," but adds he believes the analysts are overreacting to the situation.

The spokesman disclosed the Federal Reserve is currently working with the FDIC to collect weekly data from a sample of about 300 nonmember banks. Once satisfied the data are accurate, the Fed intends to add them to the weekly calculations.

The Fed itself is untrusting of the money supply numbers. Late last fall, for example, the money stock surged. Because of the lack of confidence in the numbers, the Fed chose to ignore the increase, according to Lanston's Mr. Jones. The Fed instead attributed the bulge to special factors, saying the increase reflected less efficient use of funds by corporations. Mr. Jones states that later figures showed, however, that the bulge was real, reflecting a boom in "credit and money for sharply expanding spending."

Mr. GREEN. As I understand it, the percentage of nonmember deposits as opposed to the total deposits has increased from approximately 15 percent to approximately 30 percent in recent years. I gather, and your testimony indicates, Chairman LeMaistre, that at present we have a system whereby there is a full report on those deposits on a quarterly basis and there is a sampling on a weekly basis in the interim. Am I correct on that?

Chairman LEMAISTRE. We are collecting from 580 banks, as I recall it.

Mr. GREEN. Yet apparently the data the Fed are using, or at least their estimates derived from that data, seem to have an effect of systematically understating the money supply, at least based on the upward revisions they have to make on the basis of the quarterly data. That is demonstrated by the fact that five of the six last quarterly adjustments have had to be upward adjustments. For example, I believe the June 14th adjustment shows that the money supply had risen by 8.1 percent whereas the Fed's estimate based on the sampling data had been 7.5 percent.

I guess my concern is this: You indicate the legislation I submitted, H.R. 13549, is not necessary. Of course I acknowledge that what I proposed to do or something similar to that could be done administratively without legislation.

Chairman LEMAISTRE. That is the thrust of my statement. The statistics are available. They can be collected if they are needed.

Mr. GREEN. I guess my concern is that your testimony indicates that the Fed and you are not going to be taking a look at the situation until mid-1979. It would seem to me on the basis of the data I have cited that it is pretty clear that the system, as it now exists, is not working correctly and is causing significant problems in terms of the Fed open market operations as a result of the interim underestimate of the growth in the money supply.

Would it not be well to look at it more quickly?

Chairman LEMAISTRE. I think that could be done. The date of 1979 was set in 1977 when we started collecting this. We agreed in 2 years we would look at it. There is no reason why we couldn't look earlier. However, I am not at all sure the adjustment was made necessary by misinformation in the 27 percent held in nonmember banks. I think the adjustment was due to some improper estimates across the board. Certainly we can proceed to collect from a larger sample, from all of them or whatever is necessary. I am not aware that we have been asked to increase the size of the sample in recent months. But we do not have to wait until 1979 to consider the question.

Mr. GREEN. Again, if I may turn to Mr. Leonard, the sample I proposed, based on discussions I had with economists in the field, was a sample from at least 1,000 nonmember banks, including all those having deposits exceeding $100 million. Would that be onerous in your eyes?

Mr. LEONARD. No, if it was necessary for the Fed to be more accurate in its predictions.

Mr. GREEN. That is all I have.

The CHAIRMAN. Chairman LeMaistre, I want to take this opportunity to pay my tribute to you as an outstanding public servant and a fine gentleman. It has been a pleasure to have you helping us over these years. I know every member of the committee wishes you all the best.

Chairman LeMaistre. Thank you, sir. You are very kind.

The Chairman. I have a question for several people. I will start with you, Chairman LeMaistre.

Suppose we were to replace the existing structure of reserve requirements, which as you know varies, and even the amendment proposed by some members of this committee which is before us, keeps that variation. In your testimony, you indicated that you didn't agree with that, as well as with the existing system.

Suppose we were to replace the system of varying marginal reserve requirements with a single, uniform rate applicable to all deposits of member banks, exempting, let us say the first $30 or $40 or $50 million of total deposits. In your judgment, would this constitute a significant improvement in monetary control, over what we now have?

Chairman LeMaistre. I have to come back to what all the economists have said and that is, it doesn't really affect monetary control; that the operation of our monetary policy doesn't depend really on how much is kept in reserves.

The Chairman. To the extent we do have reserves, to the extent that a decision is not made to do away with reserves and rely on open market policy and the discount window, would it not be a more effective method of monetary control than one such as we now have where a dollar deposited at the Continental Illinois or Citibank has a different monetary value from a dollar deposited at the State bank in Podunk?

Chairman LeMaistre. I would say in my opinion it would definitely encourage membership, if by setting a uniform rate you lowered it from the top rates today and reached somewhere between the low and the top.

The Federal Reserve itself in 1972 restructured the reserves and put a graduated system—which it seems to me is a little counter to what they are saying is necessary now—so I would say it would be more equitable.

I would defer to Mr. Olsen though as to the ultimate effect of it.

The Chairman. I am interested in the equity aspects of it, of course, but I want to put the question again. In terms of monetary control, even though you have cited the testimony of numerous respective experts that reserve requirements don't mean a thing, as far as monetary control is concerned, suppose those experts are wrong and suppose the Fed is right?

Chairman LeMaistre. And that could be.

The Chairman. Would we not get then a surer and less diffused type of monetary control? If you had a single uniform reserve requirement then, with our present system where a dollar happens to be deposited, that has a great deal of purely fortuitous effect on monetary policy.

Chairman LeMaistre. Mr. Chairman, I think you are right.

As far as monetary control goes, we probably would achieve a better balance. I am not sure that you wouldn't really be moving counter to the proposals to increase membership though because obviously this would raise the level of those who are at the lowest level now and if

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they are already worried about what it costs them, to add to their membership burden, it would probably encourage them to get out.

The CHAIRMAN. My question really has nothing to do with membership because I was impressed by your testimony and that of others which said what we are really concerned with is to assure an effective monetary policy, to get an efficient payments system and to eliminate arbitrary forms of discrimination against particular types of financial institutions. That happens to be the ABA's triology but it sounds pretty good to me, and membership is not mentioned.

Chairman LEMAISTRE. Without regard to membership, I think it would be better, yes.

The CHAIRMAN. Mr. Leonard, I would like to ask you the same question.

Mr. LEONARD. My answer would be essentially the same as Chairman LeMaistre.

Being a bank administrator, it would give me some concern if you came out with the idea that member banks were required to carry zero reserve on the first x dollars in deposits. Most of the bankers in prudent operations of the bank would still continue to maintain some type of liquidity type reserve. However, there is that element who retains reserves because the law says they have to have a reserve.

The CHAIRMAN. However, as a State bank regulator, you could impose whatever liquidity reserve requirements you wanted on your State banks, member or nonmember.

Mr. LEONARD. For liquidity purposes, yes. If the national banks then would retain that liquidity reserve requirement, I think what you are saying would be very well.

The CHAIRMAN. I think there is a point to the criticism that has been made during these hearings. It was actually made by Chairman LeMaistre this morning when he said on page 4 that because of deposits being subjected to different requirements and different size classes.

A shift of funds among member banks has precisely the same effect of blurring the precision of monetary policy that disturbs the Federal Reserve when nonmember banks are involved.

Would you agree with that general proposition?

Mr. LEONARD. Yes.

The CHAIRMAN. How about you, Mr. Perkins?

Mr. PERKINS. Two points.

One, uniform reserves across the whole system would be quite desirable, I think, for theoretical as well as fairness reasons.

The question of setting those reserves though at one fixed figure in the law, I believe would be a mistake. I believe the Congress should set a ceiling amount.

We suggested that the minimum could be as low as zero, and that the adjustment of reserves should be left as a tool of monetary policy. I don't disagree with the theory on the question of reserves, the economic reason why you can use the market operations—but the fact is, it is a tool to effect the level of free reserves in the system which on probably relatively limited occasions might be something good to have in the bag.

Mr. OLSON. I tend to agree. I emphasize the lack of uniformity in reserve requirements as the source of some degree of volatility, if you will, in the changes in the monetary aggregates. The reason the Federal Reserve has difficulty at times in hitting its targets can be attributed to the differences in the reserve requirements as the public's preference for holding deposits swings from demand to time deposits. Uniformity of reserve requirements, I think, would be desirable.

Setting the reserves by statute, however, troubles me. It troubles me because, as you say, reserves aren't that important and it hasn't been used, but I can't see the purpose of setting it in statute. Similarly with the discount rate, I am troubled when something is fixed by statute in that particular area when there is no purposes for fixing it by State.

The Federal Reserve can hold it unchanged administratively, and in fact have used it infrequently.

The CHAIRMAN. It doesn't though. That is part of the trouble. Congress is partly at fault. The Fed is also at fault and I think the blame lies in both places, coexistent with this system which Mr. LeMaistre and everybody else has criticized. Where the deposit of $1 in one bank rather than a bank of another size can make tremendouss differences and drive people out of their wits.

One additional question: Suppose Congress did set a minimum limit of zero, no reserve requirements in effect, and whatever maximum Congress decided on: 5, 10, 15, 20 percent, whatever it is, and suppose you had some years of a responsible bank-oriented Federal Reserve and they had the requirement at zero, and then suppose the composition of the Board changed.

You in the banking system would have rendered yourself vulnerable to a quasi-tax liability hitherto undreamed of, would you not?

In other words, if you were at zero and for another 10 years the world had been settled on the creed that reserves are terribly important, it would be an easy matter for the Federal Reserve Board to tax the banking system an additional $20 billion a year by saying, "Oh, my, we have got to get out of this open market business and raise reserves and be responsible."

Mr. PERKINS. I think that is clearly a threat when the possibility exists, but that is a possibility we would have to hope would be faced carefully and in a reasonable, statesmanlike way.

The CHAIRMAN. One final question. You said zero reserves. I think you will admit that is about as much as you can ask for. What about something in between our present structure which goes from 3 percent for time and 7 percent and on up to 22 percent I think for banks of your size.

What about some sort of a compromise which gives some flexibility to the Fed, but not the complete swing of the pendulum flexibility you are talking about. What about a minimum of 5 percent and no maximum, or a maximum of 15 percent, or something like that? Something less stupendous than from zero to infinity.

Mr. PERKINS. I wasn't thinking of zero to infinity. I think our position was the top level needs to be lowered and I am sure I don't know what that figure properly would be. It would obviously have to be done over a period of time and geared into the open market operations.

Whether your suggested figures, 5 to 15 percent, make sense, I would certainly opt for a lower ceiling than that.

The CHAIRMAN. Mr. Gonzalez.

Mr. GONZALEZ. Thank you, Mr. Chairman.

In reading over the testimony, Mr. Perkins, I notice what appears to be an inconsistency. Maybe it isn't.

On page 3 you say:

> The need for mandatory universal reserve requirements on transaction accounts held by all depository institutions in order to assure an effective monetary policy has not been demonstrated. We opposed this proposal as unjustified and likely to harm our Nation's innovative system of dual banking.

Then on page 4 you say:

> We disagree with the proposal that would legislate inflexible reserve requirements because this would tie the hands of the Fed in its ability to use changes in reserve requirements as a tool of monetary policy.

I can't reconcile those two statements. Either you are right about reserves susceptible of being used as a monetary policy tool or there is no fear it doesn't or does.

Mr. PERKINS. It does appear contradictory, but I think both statements would hold up in the sense that, as we said in the first statement, and as has been discussed here, the reserve requirements are not necessary for monetary policy. There are alternative ways to effect a level of reserve in the total system. Namely, open market operations.

On the other hand, the availability of the tool of adjusting reserves required can affect the level of reserves in the system that can be used by the banks or held sterile by the banks. There may be an occasion when you would want to reduce the amount of free reserves in the system, for example, that could be used by the banks. That would be done by raising reserve requirements rather than simply taking the reserves out of the system through open market operations.

Mr. GONZALES. Also in your statement, on page 6 of your testimony with reference to the fact that the withdrawal of members has resulted in a loss of $200 million to the Treasury, I notice you refer to the fact that this was a figure given by Chairman Miller, which is true, but which also has raised a question when he made that statement and that is, isn't it a fact though that, had a plan been devised in 1970 say, to hold at that level the membership then present, that the cost of doing that would have probably exceeded the $200 million?

In other words, I don't think you want to leave the impression that the erstwhile cost of $200 million in reality could have been avoided.

Mr. PERKINS. I don't disagree. Use of a figure like this by itself can be quite deceiving. Obviously, there are all kinds of factors that say if so and so had happened in so and so, then it would have computed up to *x* dollars. That was simply used, I think, as a suggestion of just the withdrawal based on a very theoretical concept, but there are all kinds of other things involved.

For example, what about newly chartered banks, if they don't enter the System?

Mr. GONZALES. Thank you very much, sir.

Mr. MITCHELL. The gentleman from South Carolina.

Mr. DERRICK. Thank you, Mr. Chairman.

I have a question that is not an original question with me; I won't make any pretense, I will just read it.

Suppose the discount rate were linked to the Treasury bill rate formula but the Fed had the power to depart from the formula which would be for 1 week and renewable.

Wouldn't this provide ample flexibility and at the same time assure that administrative changes in the rate would not give misleading signals?

Now, when the discount rate is raised or lowered, we cannot always be sure whether the Fed is easing or tightening because the Treasury bill rate may have previously moved in the same direction.

Under the provision I have in mind, an administrative change would not be misinterpreted. Increasing the rate more than called for by the formula would unambiguously indicate a tighter policy. Decreasing it below the rate called for by the formula would unambiguously indicate an easier policy.

Would you comment? Would you like a copy of the question?

Mr. PERKINS. I am not sure it is all that simple.

If you had a system like that, it may, for example, right now the Treasury bill rate is probably lower, say a week or two ago, than it would have been otherwise, but it was affected by the fact that in a series of financings and refinancings the Treasury followed, chose not to increase Treasury bills to finance a deficit but to use intermediate term and longer term securities. So, you get all kinds of factors that press on a particular rate when you are doing it that way.

I don't really think it would be that simple.

Mr. OLSEN. There was one part of the question I would ask you to repeat. You say for 1 week and then it could be renewed?

Mr. DERRICK. Renewable, that is correct.

Mr. OLSEN. How would they go about getting it renewed then, because coming to Congress or——

Mr. DERRICK. I am told by a vote of the Board.

Mr. OLSEN. By a vote of the Board. Well, what troubles me about the tying it to the Treasury bill this way, is again, you are financing something in statute that is in the monetary policy area. When you are dealing with the market forces, I would feel that a degree of flexibility is desirable if I were conducting monetary policy. It is troubling to fix it in the statute.

I personally see no objection, and I would feel the Federal Reserve should administratively, from time to time, have the discount rate closer to a market level or higher level. But financing it to the Treasury bill in a statutory fashion means that you cannot anticipate the times when the Federal Reserve might be free to do that.

If they are going to be able to change it for a 1-week period subject to renewal, my question is, why must you fix it in statute?

Mr. MITCHELL. It is only fixed, of course, if the Board wants it fixed, and that is the flexibility.

Mr. OLSEN. They would not otherwise change it.

Mr. DERRICK. The Board is the master of its own destiny.

Mr. OLSEN. I would assume under such proposal the Fed might well opt for an extended period of time renewing it every week to have it deviate from the Treasury bill, which would mean it would not be a major change from the situation you may have now, except the Federal Reserve would be reviewing it every week.

Now, that might create some problems from the standpoint of the market's reading of it.

Mr. DERRICK. Of course, it would necessitate their taking that positive action though.

Mr. OLSEN. Yes. There is one other aspect of this Mr. Perkins touched on also, and that is that the discount rate is viewed abroad differently than it is at home and, given the breadth of the dollar market internationally today and the exchange rate situation, this is important.

The discount rate here is viewed abroad comparable to the bank rate in England or the bank rate in Germany, so the ability to change the discount rate here does have a signal and a meaning abroad that would be impaired if you were to tie it to a Treasury bill this way.

Mr. PERKINS. I think on that point, on the international side, whether or not this is desirable at a time when the dollar is being questioned so widely, a congressional action on the discount rate would be very upsetting in the international financial markets, just because of the tradition of these hundreds of years of the way it is viewed abroad.

Mr. DERRICK. Does Chairman LeMaistre or anyone else care to comment?

Thank you very much.

I yield back the balance of my time, Mr. Chairman.

Mr. MITCHELL. Mr. Stanton is recognized for 5 minutes.

Mr. STANTON. Yes. We don't want to hold you here, but we don't have this opportunity very often to get such a divergence of views.

Getting back to this subject which we have zeroed in on, due to the Chairman's comments on the subject of payment of interest or reducing reserve requirements, theoretically, if you were to carry that out, then the subject of paying interest on reserves, the type of interest could become a moot question, am I correct on that, Mr. Olsen?

Mr. Perkins——

Mr. LEMAISTRE. I think certainly if there are no reserves, it wouldn't be a problem, but the burden would be reduced either way.

Mr. STANTON. Mr. Leonard, I wondered if you could tell, I think it was Chairman LeMaistre in his statement who spoke of 36 States now, I think, that allow State nonmembership banks to hold reserves in different types of deposits of interest-bearing securities, different types of securities. Where did the historical, nonpayment of interest come into the Federal Reserve or, at the same time, why did the States go out on their own in declaring the different types of deposits that could be held?

Mr. LEONARD. I am not really sure I know where the history came from on the sterile reserves for Federal Reserve banks in the 30-odd States that permit their State banks to carry at least all or part of their reserves in interest-bearing–type instruments, and so forth.

I presume it was just the wisdom of the State legislature in their various States.

Dr. KREIDER. Mr. Stanton, on the question of the States paying interest or permitting reserves to be in the form of interest-bearing assets, and I am sure Chairman LeMaistre did not mean to overstate that, but simply stating 30-some States in one form or another do this, is, in fact, an overstatement.

In the overall picture, a relatively small percent of the total reserves of State-chartered nonmember banks is in the form of interest-bearing reserves. It is a small percent of the total. We could get estimates on that for the committee if the committee would so desire, but it should not be assumed that that is a big factor in State-chartered reserves.

Mr. STANTON. That is mainly what I wanted to get at, is how big a factor it was.

Mr. MITCHELL. Gentlemen, you have been most kind.

I have many more questions which I will not put because you have been here so long. Forgive my temporary absence.

Mr. Grassley has joined us. I don't think he has had an opportunity to raise questions, and then Mrs. Fenwick on the second go-around, and that will wrap it up.

Mr. Grassley is recognized for 5 minutes.

Mr. GRASSLEY. Thank you, Mr. Chairman.

I would start out by asking Mr. Wicks, when your bank was a member of the Fed how often did your bank use check-clearing services provided by the Fed?

Mr. WICKS. We used the check-clearing services on a daily basis.

Mr. GRASSLEY. So you did that instead of going through a correspondent bank?

Mr. WICKS. That is correct.

Mr. GRASSLEY. OK. I ought to follow this up, Mr. Wicks. At least while you were a member you had a good, complete, thorough business relationship with the Reserve?

Mr. WICKS. Excellent, yes.

Mr. GRASSLEY. And at least for the period of time you were in it you found adequate need to use the services and did, in fact, use them as completely as you could.

Mr. WICKS. We certainly did.

Mr. GRASSLEY. Next I have a question for Mr. Leonard.

On page 4 you list items that should be addressed by a congressional program to correct the membership problem. Your fourth item is to permit the private correspondent banking system to compete more effectively for correspondent business. Now, what changes does this involve other than the obvious one that the Fed is going to have to have a competitive pricing system for its services if we go that route?

Mr. LEONARD. You mean if you go the route of the Fed pricing their services?

Mr. GRASSLEY. Yes. Obviously, in that particular case you are suggesting that the Fed is going to have to price its services competitively as opposed to just the subject or the proposition of pricing per se.

Mr. LEONARD. Yes. The pricing of the Fed, if they are going to price their services, should not be subsidized by taxpayers' money. The Fed ought to price their services at no lower than private enterprise can afford to provide that same service.

However, in connection with the pricing of services, the correspondent banking system gives considerably more services to their correspondents than does the Fed, for example, in financial advisory, municipal bond accounts, those types of things that are not available at the Fed.

Mr. GRASSLEY. Also, then, I am wondering if from your standpoint, you feel that the Federal Reserve has a cost accounting system that is going to be able to give us very definite figures on what exactly these costs will be, so that it will be easy for us to compare the prices charged by the Fed vis-a-vis those charged by correspondent banks? Or do you think we will get into problems here where the Fed could find justification for having lower costs for some reason or other?

Mr. LEONARD. I would hope that the Fed would have the capability of coming up to you all with a cost analysis on what it would cost. With the economists and accountants and everything else they have, certainly the Fed has that capability.

I don't know if they have done it yet or not.

I have some reservations about whether or not the Fed can offer a service at the same price private enterprise can. The Government sometimes has problems internally or something else where they always seem to cost more than what private enterprise costs. That is my personal opinion, but it gives me some concern sometimes.

Mr. GRASSLEY. I carried on this discussion with Mr. Miller when he was here, and he assured us that even though the Fed has not quite reached this point yet that its cost accounting would be able to provide these figures, that we would definitely know if they were competitive or not.

But he did speculate that it might be some period of time after the installation by the Fed of the pricing mechanism before we could expect them to be fully competitive because of, I guess what I would call, startup costs.

I just point that out to you, because they are saying that point is going to come. I wonder, Mr. Chairman, if I can have time just for one last question?

I have a message my time is up. Could I ask another question of Mr. Wicks?

Mr. MITCHELL. The gentleman's time has expired, but we are in a very expansive mood this morning.

Please proceed.

Mr. GRASSLEY. I was wondering, Mr. Wicks, what if the cost of carrying sterile reserves was cut in half, or maybe I should not say just in half, but at least cut considerably, would you imagine that this would stop the decline in Fed membership?

Mr. WICKS. I think it would be a definite factor, yes. I don't know as it would stop it. I think again looking at all of the opportunity costs of being a member of the Fed still would be the decision that would be made by any banker as to whether he should stay in or not.

Mr. GRASSLEY. As inflation increases, interest rates go up; as the interest rates go up, then there is a greater cost to the individual banks because their reserves are sterile. Is there not then some connection between the Fed's ability to keep inflation under control, to keep interest rates down and hence the cost of sterile reserves down and the protection and encouragement of membership?

Mr. WICKS. I think that is a very definite factor. As the inflation goes up, as interest rates go up, the opportunity costs of going out of the Fed are greater, and this is certainly a very important part of, I think, the decision of members to pull out.

Mr. GRASSLEY. From the standpoint of the Fed being a very strong mechanism in our war on inflation, then fighting that battle more aggressively would, in fact, stop the decline in Fed membership.

Mr. WICKS. I think it would be a definite factor, yes.

Mr. GRASSLEY. Thank you, Mr. Chairman.

Mr. MITCHELL. The gentlelady from New Jersey.

Mrs. FENWICK. Thank you.

I would like to go back to the question of the reserves.

Mr. Perkins, at one point, said that the mandatory universal reserve requirements would be damaging and, Chairman LeMaistre, if I understood it, also felt that this would damage the dual system. On the other hand, I have just heard in later testimony from Mr. Perkins that a theory of universal reserves is good.

The lack of uniformity, said Mr. Olsen, in the reserve requirements, makes it difficult for Federal Reserve to execute monetary policy because public demand shifts from one form to another.

What do I hear; am I correct in understanding that you believe, all of you, that some form of universal reserve requirement would be useful, equitable and desirable, provided that it were not set by statute, but were left to whom?

That is what I am trying to get, to whom would you leave the decision as to what those reserve requirements should be, or to which agency or group of agencies or to whom, Mr. Olsen?

Mr. Perkins, who would be setting that? I realize it would have to shift if there were variations in the monetary situation.

Mr. PERKINS. There are all kinds of possibilities. I would think that with the Federal Reserve charged with the Nation's monetary policy as the central bank, that that would be the most likely administrative place.

Mrs. FENWICK. Would you be satisfied to see that?

Mr. PERKINS. There are really two questions: One is the setting of reserves and the other is the question of reserve requirements, compulsory for all institutions. Our position has been that in our State-Federal system we would oppose that.

Mrs. FENWICK. I know, but doesn't that sound like a contradictory position? On the one hand you are saying, yes, we must have reserve requirements, and in the second place you are saying they should not be mandatory.

Mr. PERKINS. No; I don't believe I said we must have reserve requirements.

Mrs. FENWICK. You don't believe in having reserve requirements then?

"The theory of universal reserve requirements is good," you said; didn't you?

Mr. PERKINS. Yes.

Mrs. FENWICK. What were you talking about? What is good, if not universal reserve requirements?

Mr. PERKINS. Good in the sense that to the extent that you have equality you don't have unfairness built into the system of advantages or disadvantages.

Mrs. FENWICK. But aren't you in favor of that?

Mr. PERKINS. Yes; I am in favor of having what we have also referred to as an equal playing field among different types of institutions.

Mrs. FENWICK. Yes, but Mr. Perkins, follow through.

How do you suggest doing it? Who is going to do it?

Mr. PERKINS. Our suggestion was that possibly we look at the total federally chartered institution and maintain the State-Federal separation for the nonfederally supervised and chartered institutions.

Mrs. FENWICK. Yes, but who is going to set these universal requirements that you say would be useful?

Mr. PERKINS. I would think the Federal Reserve would be the proper body with the proper——

Mrs. FENWICK. But you just said that was not a good thing.

Mr. PERKINS. Now, wait, you asked me if you did that——

Mrs. FENWICK. No; I am saying, one, am I correct in quoting you as saying, "The theory of universal reserves is good." But the level required, as I understand it, "should be left to the open market." Do I quote you correctly?

Mr. PERKINS. I don't believe so; no, ma'am.

Mrs. FENWICK. "The theory of universal reserves is good." You did say that.

Mr. PERKINS. Yes, on the basis of equity all across.

Mrs. FENWICK. Then you certainly are for equity.

Mr. PERKINS. Yes, ma'am.

Mrs. FENWICK. Who is going to set this universal reserve requirement?

Mr. PERKINS. I think while the theory is good we would oppose a universal requirement because of the other more overriding considerations of the State-Federal.

Mrs. FENWICK. More overriding than equity?

Mr. PERKINS. When you put it that way——

Mrs. FENWICK. You see, I am trying, Mr. Perkins, you cannot imagine how illogical this whole banking things looks.

Mr. PERKINS. There are lots of illogical parts to it, yes, ma'am.

Mrs. FENWICK. I have listened carefully to all of you who are so qualified, and certainly I am not, but I am trying to understand the distilled wisdom. If a theory of universal reserve requirements is equitable and just, surely we must try to approach it. Now, if we are going to try to approach it, how do you approach it in such a way as to not throw over the whole applecart?

Mr. PERKINS. I don't believe I am making myself clear.

Mrs. FENWICK. No.

Mr. PERKINS. But when we say we are having to weigh different desirable aspects of things——

Mrs. FENWICK. But how do you control monetary policy?

According to Mr. Olsen, the lack of uniformity in reserve requirements as public demand shifts from one to another makes it difficult for the Federal Reserve to execute monetary policy.

Mr. PERKINS. Well, he is talking about a different kind of universal. He is not talking about universal reserve requirements there. He is talking about the fact that depending on what size bank you are at a particular moment, that there are differences in the reserve requirements. But only to the member banks.

Mrs. FENWICK. The lack of uniformity, which certainly suggests uniformity.

Mr. PERKINS. Yes.

Mrs. FENWICK. Now, uniformity covering whom, covering which banks?

Mr. PERKINS. Our suggestion was it would cover, if it went that route, federally chartered depository institutions.

Mrs. FENWICK. So what you would like to see is the theory of reserves being set because it is equitable and just, but it should apply only to Federal banks, leaving the State banks to be inequitable and unjust?

Mr. PERKINS. At some point we have to perhaps pay a price in equity or inequity for what we consider very important things, such as the State-Federal, the whole concept.

Mrs. FENWICK. The only justification for the dual system we have had today was from Chairman LeMaistre, as I understood it which was that you get innovations such as the NOW accounts in the New England States, and so on. I don't know that it is worth paying in justice and equity for so little, is it?

Mr. PERKINS. I think that is obviously a very difficult question, but at some point the question of not having one overall Federal operation as opposed to having some diversity in the system, I think, has a lot of pluses, such as innovation.

Mr. OLSEN. Could I share partly in that answer, Mrs. Fenwick?

Mrs. FENWICK. Yes, Mr. Olsen.

Mr. OLSEN. First, I want to make a distinction between the universal reserve requirements and the fact that you now have different rates of requirements among institutions, and types of deposit reserves—time deposits are lower against demand deposits.

That creates problems in monetary policy, the fact that you have differences. Now, universal reserve requirements, which the Federal Reserve Board has proposed, means extending reserve requirements to all depository institutions. They have intimated that possibly if this were done, they would not pursue the matter of enabling the banks to earn interest on those.

Now, that obviously would be offensive to those banks that are not now members of the Federal Reserve and who earn interest on their reserves. In other words, they would be forced to go back into a system that they left. They would be opposed to that, and that is inequitable to force them back into holding noninterest assets.

Mrs. FENWICK. I agree, but I don't see why you would have to force them into holding nonearning assets simply if you set reserve requirements. Why couldn't you set reserve requirements that would allow for interest bearing reserves?

Mr. OLSEN. You could do that; yes, you could.

Mrs. FENWICK. Wouldn't that be the sensible thing to do and get justice and interest, too?

Mr. OLSEN. That has not been proposed at this point, but that would be justice, yes.

I might add one other point, that the Federal Reserve sets reserve requirements today. Many States, as I understand it, set their reserve requirements along with the Federal Reserve, in many cases, not universally, but some.

Mrs. FENWICK. My time has expired, but, honestly, I could listen all day.

Mr. MITCHELL. The gentlelady's time has expired. But I, too, was fascinated by your spirited line of questioning.

The committee will adjourn now because we have had the witnesses for quite a while and it is almost high noon. I am glad we have come to an end of this session of the hearings on that rather spirited line of inquiry which all of us found fascinating.

Gentlemen, thank you very much for being here. You have been very patient and kind and cooperative, and we are most appreciative.

For the members of the committee, the last round of hearings will be scheduled next Friday at 9 o'clock.

Gentlemen, thank you very much.

Mr. PERKINS. Thank you, Mr. Mitchell.

Mr. WICKS. Thank you, sir.

Mr. LEONARD. Thank you.

Chairman LEMAISTRE. Thank you, Mr. Chairman.

Mr. MITCHELL. The committee stands adjourned.

[Whereupon, at 12:00 noon the committee adjourned, to reconvene on Friday, August 11, 1978.]

MONETARY CONTROL AND THE MEMBERSHIP PROBLEM

FRIDAY, AUGUST 11, 1978

House of Representatives,
Committee on Banking, Finance and Urban Affairs,
Washington, D.C.

The committee met, pursuant to notice, at 9:05 a.m., in room 2128, the Rayburn House Office Building, Hon. Parren J. Mitchell presiding.

Present: Representatives Reuss (chairman of the committee), Mitchell, Spellman, AuCoin, Cavanaugh, Vento, Stanton, Hansen, Fenwick, and Green.

Mr. Mitchell. This hearing will now come to order.

Today we continue our hearings on proposals designed to improve the implementation of monetary policy, promote competitive equity among banks, and ease the problem of Federal Reserve membership.

We have had before us three bills and an amendment to one of these bills: H.R. 13476, H.R. 13477, Federal Reserve proposals submitted by request; H.R. 12706, the Stanton bill, and an amendment to the Stanton bill.

Our hearings so far have illuminated some problems with each of these proposals and have brought forth many constructive suggestions. As a result of these hearings, we now want to consider another proposal which appears to have a great deal of merit and we would welcome any comments that the witnesses may have on this proposal as well as those considered in the testimony you have submitted.

I understand that all witnesses have been informed of the new proposal but I appreciate that you have not had much chance to study it.

The new proposal is a very simple bill consisting of two titles: First, it would authorize the Federal Reserve to obtain whatever information it needs for purposes of better monetary control from all depository institutions through the appropriate regulatory agencies; and second, it would restructure reserve requirements so that the first $100 million of reservable liabilities of commercial banks would be exempt from any reserve requirement, while all commercial banks would be subject to reserve requirements on such liabilities over $100 million—with reservable liabilities meaning demand deposits, time and savings deposits and overnight bank borrowings. These reserve requirements would be subject to a uniform rate of 6 percent, with the Federal Reserve authorized to increase or decrease that by one-half percent for purposes of monetary control only.

Thus all banks of less than $100 million in reservable liabilities will be exempt, while the bigger banks will all be treated alike in terms of reserve requirements, whether members of the Federal Reserve System or not.

I would emphasize that nothing in this proposal would change the supervision or regulation of banks as between Federal and State authorities. Nonmember banks of over $100 million, while required to hold reserves, would not be brought under Federal Reserve regulation in any way.

One of the major advantages of this proposal is that the cost to the Treasury would be only about $150 million, several hundred million dollars less than any of the previous proposals.

Our witnesses today will be: Henry Schechter, director, Department of Urban Affairs, AFL-CIO; Jerry Jordan, senior vice president and economist, Pittsburgh National Bank, Pittsburgh, Pa.; Prof. Paul McCracken, University of Michigan; Prof. Thomas Mayer, University of California at Davis; William M. Crozier, Jr., chairman and president, BayBanks, Inc., Boston, Mass., and Mr. Bernhard W. Romberg, president, Payment and Administrative Communications Corp., New York, N.Y.

Gentlemen, we welcome all of you and we are most grateful that you could take time out of your busy schedules to be with us this morning.

Other members of the committee will be joining us shortly. If you have been following the papers recently, the Congress is working incredibly long hours and I think there might be some battle fatigue beginning to show. We do, however, expect a good turnout of the members this morning.

We have received copies of statements and I would appreciate it in the interest of time if you would submit the statement for the record in its entirety and perhaps try to summarize your testimony in 10 or 15 minutes. Thank you.

I think logic would dictate we start on my left with Mr. Schechter and proceed down the line.

STATEMENT OF HENRY SCHECHTER, DIRECTOR, DEPARTMENT OF URBAN AFFAIRS, AFL-CIO

Mr. SCHECHTER. Mr. Chairman, I appreciate the opportunity to present before your committee the views of the AFL-CIO dealing with proposed legislation on reserve requirements of depository institutions. The proposals involve the interests of private financial institutions and of the public. They would have a bearing on the financial structure and stability of the national economy. These are matters in which the AFL-CIO has had a continuing concern.

The conditions giving rise to the bills under consideration can be stated briefly. Over the past decade there has been a decline in bank membership in the Federal Reserve System. The Federal Reserve Board claims that it tends to weaken the financial system, as more financial transactions are carried on outside of Federal Reserve regulatory channels and the implementation of monetary policy becomes more difficult. The decline in the Federal Reserve membership has been attributed to the fact that member banks are required to hold a relatively large proportion of assets in noninterest bearing reserve accounts than nonmember banks or other institutions.

To deal with the Federal Reserve System membership problem, two basic courses of action are under consideration in proposed legislation. One is to authorize the Federal Reserve banks to begin to pay banks interest on reserve deposits, at a continuing annual expense of several hundred million dollars a year to the U.S. Treasury and the American taxpayers. The other is to require nonmember banks and other depository institutions, whose deposits are insured by the Federal Government, to have the same noninterest bearing reserves as member banks on demand and similar deposits, with some exemptions for smaller institutions.

Each of these two major courses of action can be assessed in light of the overriding need for effective control of monetary policy and therefore the need to halt Fed membership erosion.

PAYMENT OF INTEREST ON RESERVE DEPOSITS

In connection with proposals for the Fed to pay interest on reserves, it should be noted that presently the Federal Reserve pays no interest on member bank reserves. After paying a statutory 6-percent dividend on stock held by member banks, and adding as much as necessary to each Federal Reserve bank's surplus to keep it equal to its paid-in capital stock, the rest of the Federal Reserve bank's net earnings are turned over to the Treasury. Therefore, the total amount of annual payments of interest on reserves would reduce the annual Federal Reserve payment to the Treasury by an equal amount.

Furthermore, if the Federal Reserve banks have accumulated excess surplus funds, such excess surplus funds are a result of past misjudgments of how much of Federal Reserve net earnings needed to be retained in the Fed surplus, instead of being turned over to Treasury at the time.

Such funds really represent deferred payments due to the Treasury. That interpretation would seem to be in accordance with a statutory provision that in the event of dissolution of a Federal Reserve bank, after payment of debts and par value of stock, remaining surplus funds are to become the property of the United States. The use of such excess surplus funds to help pay interest on reserves would represent a diversion of Treasury revenues, just as would the use of current year Fed earnings to pay interest.

Finally, the excess surplus funds are limited and could not offset the Treasury losses after 2 or 3 years.

In estimating costs to the Treasury of interest payments on reserves, therefore, a transfer of excess Federal Reserve bank surplus funds to the Treasury should not be looked upon as an offset to the interest payments. The total annual Treasury revenue loans from payment of interest on reserves has been estimated at $765 million under the proposed Federal Reserve formula in H.R. 13477, the Interest on Reserves Act of 1978, and $450 million under a formula in the proposed Reuss amendment to H.R. 12706, the Federal Reserve Membership Act of 1978. These estimates and those to be cited later appear on page H6780 of the Congressional Record of July 14, 1978, as part of Chairman Reuss' statement introducing the bills. H.R. 12706 itself would direct the Fed to pay interest on reserves at a rate not to exceed the average rate on Treasury 3-month bills in the preceding calendar quarter, an uncapped amount.

The payment of interest on required reserves of depository institutions is neither necessary to deal with the related problems of Fed membership attrition and achievement of more effective monetary policy, nor desirable from a public-interest point of view.

It is elementary that interest payments on reserves would provide commercial banks with a substantial windfall at the expense of the Treasury and American taxpayers.

The so-called burden borne by banks in complying with the reserve requirements is part of the cost of conducting a business which must be a joint public-private venture, in order to minimize general economic instability. Depository institutions are given Government franchises to operate, and protected from injurious competition by the regulatory authorities who control the chartering of new institutions and branches.

The depository institutions are the guardians of other people's money which can best be safeguarded under a monetary supply that is regulated to meet the needs of the economy without becoming too excessive or too tight. Congress has assigned that mission to the Federal Reserve, with due authority to require the maintenance of adequate reserves. The meeting of reserve requirements, therefore, is a necessary cost of the banking business, and one that the business has lived with and grown over the past 64 years.

There are two other provisions in the proposed bills that have been brought into the discussion of interest payments on reserves. One is the innovation of charges for services by Federal Reserve banks against depository institutions receiving interest payments on reserve deposits. Such charges would be made, as implied in H.R. 13477 and as directed in H.R. 12706 and under the proposed amendment to H.R. 12706. Aggregate charges have been estimated at $410 million annually.

At the same time, under H.R. 13476, the Federal Reserve Requirements Act of 1978, embodying the Fed's proposal for mandatory universal reserve requirements, and H.R. 12706 with Chairman Reuss' proposed amendments, changes in reserve requirements would reduce outstanding reserves by an estimated $5 billion. The reduction in reserves and interest that can be earned thereon would mean an estimated annual revenue loss of $350 million to the Fed and Treasury, and that much of a gain to the depository institutions.

UNIVERSAL RESERVE REQUIREMENTS

The AFL-CIO is firmly opposed to the payment of interest on reserves as a matter of public interest and also because the intended purposes can be met through universal reserve requirements along the lines that have been proposed in H.R. 13476, the Federal Reserve Requirements Act of 1978, with some modifications.

The Federal Reserve Requirements Act of 1978 would establish mandatory universal reserve requirements for all depository institutions whose deposits are federally insured. It would be applicable to insured commercial banks, nonmember as well as Fed member; mutual savings banks; savings and loan associations; and credit unions.

However, reserves on time and savings account deposits would be required only of Fed member banks, not for other depository institutions.

Reserves would be required of all depository institutions with respect to demand deposits and transaction accounts. The latter are deposits or accounts on which the depositor or account holder is allowed to make withdrawals by negotiable or transferable instrument or other similar item for the purpose of making payments to third persons or others. Among such accounts would be demand deposits, negotiable order of withdrawal accounts, and share draft accounts.

The definition of transaction accounts given in section 101 of H.R. 13476 does not include funds which can be automatically transferred from savings deposits into demand deposits. This would seem to be a serious omission from the viewpoint of effective monetary policy. To meet that deficiency, the definition of "transaction accounts" in section 3(b)(2) in the amendments to H.R. 12706 proposed by Chairman Reuss should be substituted for the definition in section 101 of H.R. 13476.

The proposed requirement in H.R. 13476 that equal reserves against demand and other transaction accounts be maintained by nonmember institutions, should remove the major inducement for member banks to leave the Federal Reserve System. Furthermore, reports from all depository institutions, as to compliance with reserve requirements, would provide the Federal Reserve with an improved basis for effective regulation of the money supply.

For small nonmember institutions there would be an exemption from reserve requirements against transaction accounts under both the Federal Reserve proposals in H.R. 13476 and also under proposed amendments to the Stanton bill, H.R. 12706.

The exemption would be $5 million under H.R. 13476 and $10 million under the proposed amendment to H.R. 12706. It is desirable that small banks, generally serving small communities, should be protected against competition from larger institutions. What the appropriate amount of exempt transaction accounts should be for this purpose we do not know.

Nonmember institutions could maintain reserve deposits at member banks. Many nonmember depository institutions, particularly small banks and thrift institutions that have transaction accounts, already maintain deposits at large member banks. To that extent, part of the nonmember reserve requirement under H.R. 13476 are probably already being met.

As far as thrift institutions are concerned, the great majority have the overwhelmingly major part or all of their deposit liabilities in the form of time and savings accounts, which would not be subject to any reserve requirements. The inflow of savings available for mortgage loans should not be adversely affected. Furthermore, in order to avoid the imposition of new supervisory authority over thrift institutions, the compliance of such institutions with reserve requirements should be supervised by their present Federal regulatory agencies, such as the Federal Home Loan Bank Board and the National Credit Union Administration.

For all of the foregoing reasons, universal reserve requirements pro-

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vided for in H.R. 13476, with suggested modifications, should prove adequate to deal with the problem of loss of Fed membership and the consequent increased difficulty of implementing monetary policy. There should not be any need for payment of interest on reserves at a large and continuing annual cost to the U.S. Treasury.

CHANGES IN MONETARY POLICY TOOLS

The proposed amendment to H.R. 12706 would make two other noteworthy changes in Federal Reserve powers for implementation of the monetary policy. One would call for the Federal Reserve discount rate on loans to members to be set at the same level as the Treasury bill rate. This would have the intended effect of precluding the opportunity for arbitrage profits when the discount rate is below the bill rate. The Fed would still be in control of the discount rate because it can exercise controlling influence over the bill rate through its open market operations. There would thus be no significant loss of the efficiency of a tool of monetary policy, while there would be a protection against the use of Fed credit through the discount window to gain arbitrage profits.

Another monetary policy tool would be completely eliminated from the Fed's kit by another proposal in the amendment to H.R. 12706, that would be to establish specific statutory requirements for member banks. They would replace a statutory range of reserve requirements within which the Fed can lower or raise the reserve requirement level. The rationale is that the Fed can implement monetary policy with open market operations and discounting, and changes in reserve requirements have been made infrequently. Nevertheless, it is the infrequent occasion, such as a liquidity crisis, when Congress' schedule might not accommodate necessary quick action to adjust reserve requirements. The shift to fixed statutory reserve requirements, therefore, could cause the loss of some needed flexibility.

I have seen the newest draft bill calling for uniform reserve requirements. I think this is a move in the right direction. It goes in the direction that I have indicated in my statement. My question is, I have not had time, certainly, to try to study the details to see what the impact would be, and I would raise one concern with respect to the uniformity and narrow flexibility to the level of the reserves that would be required; that is, the extent to which there could be response to provide greater liquidity in the event of a real liquidity crisis.

After all, we established the Federal Reserve System after we had experiences such as the financial panics, as they used to be called, of 1873, 1893, 1907, accompanied by many bank failures.

I just don't know if a 6.5-percent reserve requirement for commercial banks with deposits of over $100 million would be able to meet that, with a half percentage point margin on either side for flexibility.

I think in the desire to treat the everyday problem of mechanics and operation of costs to the Fed in charging for the services versus some reduction in requirements to make that sort of balance, we should not lose sight of the basic purpose of being able to provide liquidity.

I realize smaller banks do have larger correspondent banks with access to the Federal Reserve, but at the time of the liquidity crisis those larger banks would also be involved with their own concerns. They would be concerned primarily with their own liquidity. They might not want to risk providing additional extensions of credit to relieve liquidity problems for some of the smaller banks. I throw that up for consideration and think it merits some further consideration.

Mr. MITCHELL. Thank you very much, Mr. Schechter.

Mr. Jordan.

STATEMENT OF JERRY L. JORDAN, SENIOR VICE PRESIDENT AND ECONOMIST, PITTSBURGH NATIONAL BANK, PITTSBURGH, PA.

Mr. JORDAN. I appreciate this opportunity to present my views on the subject of reserve requirements and related issues. The prepared statement I have submitted addresses some basic principles: the way I would approach analyzing questions of the level of reserve requirements, the types of deposits that would be subject to reserve requirements, and the institutions that would be subject to reserve requirements. I will not go through that statement this morning. It refers in part to proposals of a couple weeks ago and I want to spend my time commenting on the latest proposal that Mr. Mitchell has described.

The proposal that I have read over is called "a bill to facilitate the implementation of monetary policy and to promote competitive equality among commercial banks."

I like the proposal. I like the simplicity of it and I think it gets to the fundamental problem of reserve requirements as far as monetary control is concerned.

My views on this subject, from the standpoint of an economist, are concerned with formulation and implementation of monetary policy—stabilization policy—so I cannot assure you that commercial bankers, from large or small institutions, are going to agree with my views. I speak as an economist, and not as a banker, on these issues.

The first subject I want to take up is on reporting requirements. On this topic I will comment, in part, from remarks in my prepared statement. I think there should be a new statistical measure reported by the Federal Reserve that conforms to the theoretical concept that is associated with the narrow definition of the money supply—currently referred to as M_1. I think it should consist of all currency in the hands of the public, plus all transaction-type balances at any financial institution, regardless of whether or not there is a reserve requirement on it and regardless of any kind of interest rate ceiling considerations. As long as there is a regulation Q-type ceiling on time and savings deposit interest rates which is below the rates available on competitive market instruments, all accounts from which transactions can be made directly, whether these are called demand deposits, negotiable orders of withdrawal—or NOW accounts—NINOW accounts, share drafts, pay by phone, or the new automatic transfer accounts, should be maintained separately from time and savings accounts at all institutions for bookkeeping purposes.

Data from these transactions should be collected from all the institutions for inclusion in this new narrow definition of the money supply, M_1, and the issue of the amount and the form of any reserve requirements on them and the interest rate ceilings on them can be dealt with separately from decisions regarding reserve requirements or interest ceilings on nontransaction-type deposits or accounts, such as savings and time deposits at all financial institutions.

All financial institutions hold some form of reserve balances, even in the absence of legal requirements. They hold them in the form of idle cash and idle balances at other institutions—correspondent banks or regulatory institutions.

I know of no evidence that legal reserve requirements greater than the level that would be held anyway are necessary for effective control of the money supply, but it does not follow that the imposition of reserve requirements on some transaction balances at some financial institutions, while not at others, does not affect the reliability of monetary control techniques.

Studies have shown that when you have shifts in balances among different size classes of member commercial banks that are subject to different levels of reserve ratios, then you have absorption or release of bank reserves. When a balance goes from a small member commercial bank subject to low reserve requirements, or a nonmember bank subject to none, to a large member bank subject to a high reserve requirement, that absorbs reserves. If that is not offset by the Federal Reserve, you have a contraction in money. Similarly, shifts and balances from the large banks subject to high reserve requirements to smaller banks, whether subject to reserve requirements or not, releases reserves and expands money. So to me the question of uniformity of reserve requirements is much more important than the question of universality. In fact, universality of a tiered structure of reserve requirements, as currently exists and as was proposed by the Federal Reserve, could actually make matters worse.

I would argue that the emphasis today, or in your deliberations, should be on the kind or form of uniform reserves on whomever they are imposed. This is part of the reason why I find the latest proposals so appealing.

The question of interest on reserves is absent from the latest bill. I think that is desirable—to eliminate the discussion of interest on reserve balances. Required reserves which are at a level above desired reserves—the amount of reserves that would be held anyway is a form of taxation on the institution—a license fee or right to do business as a member commercial bank. To then pay interest on those reserve balances is a form of a tax credit, or tax rebate, and I really don't see the point of giving the authority to the central bank to, in a sense, set tax levels. I would rather have a uniform reserve ratio that is set at a fairly low level and then not have any interest paid on those reserves.

The proposal that the reserve requirements be statutory is desirable so long as it is at a sufficiently low level and it is uniform. If the current tiered structure of reserve equipments is retained or one of the earlier proposals by both the Federal Reserve and others suggesting a new tiered structure is imposed, I do not think it would be desirable to be statutory whether universal or not.

The current proposal for a 6-percent reserve requirement, applied to all reservable liabilities—deposits and overnight borrowings of all commercial banks over $100 million—is desirable and having it statutory would be desirable. I understand that the proposal would allow for the reserve ratio to be changed by one-half of a percentage point in either direction for monetary policy purposes. I have no strong objection to that. I don't think it would do a great deal of harm. I also don't think it would do a great deal of good.

The Federal Reserve, through its powers to conduct open market operations—buying and selling securities—has all of the capability necessary to conduct monetary policy. The changes that they have made in reserve requirements in recent years have been either specifically stated as not for monetary policy purposes, or in fact they have gone in the wrong direction. I just don't see the necessity of that.

The current proposal exempts the first $100 million of deposits at all commercial banks and it provides for indexing that amount to keep pace with inflation. As long as we are subject to the kind of inflation that we are, I think indexing is necessary and I think that the proposal incorporated in the bill is a desirable one and I hope that it is maintained.

The form of reserve requirements is not specified in the bill. Here I would like to make some suggestions:

Certainly vault cash at all commercial banks should continue to be allowed to meet reserve requirements—this has been the case since 1959 and I think that it is desirable—plus reserve balances at the central bank, at least on all transaction balances. However, the bill says 6-percent reserves on all reservable liabilities, including time and savings deposits, and I do not think that the form of the reserves on the longer term savings certificates should be idle balances. I would suggest anything over 90 days, running out to 8 year savings certificates, need not be held in the form of idle reserve balances. To tell a commercial bank that it has to hold a 6-percent idle cash reserve against an 8-year savings certificate for liquidity purposes doesn't really seem to be necessary.

We have suggested maybe 3 percent, which is about the current average reserve requirement on time and savings accounts, be held in idle cash balances at the Federal Reserve and that the additional reserves, the other 3 percent, be held in the form of U.S. Government securities in the portfolio of the commercial bank. So on transaction balances there would be a 6-percent idle cash reserve at all commercial banks over the $100 million level—that would also include day in and day out savings deposits. In other words, anything less than the 90 days would be subject to the 6-percent idle cash reserve requirement.

Then on all time and savings certificates over 90 days, the 6-percent reserves would consist of 3 percent in idle cash, as a suggestion, and 3 percent in Government security holdings.

I would also suggest that Treasury Tax and Loan accounts should not be subject to reserve requirements. The U.S. Government's Treasury Tax and Loan account balances are not a part of the money supply. No one considers them in any theoretical or empirical way to be money, and when Treasury balances fluctuate up and down, as they do quite wildly week to week, or even day to day, this absorbs and releases reserves in the banking system. The Federal Reserve has to forecast that and try to offset it—so-called defensive operations—and I don't see the necessity of requiring that banks hold idle reserves against Government balances, so I would like to see that eliminated.

Other proposals have previously been made that are not part of the current bill, and maybe should be considered at a later time, because I think they are desirable.

I think the elimination of lagged reserve requirements would be a good idea. If we didn't have them already no one would be suggesting that we impose lagged reserve requirements. We have continued them for reasons of inertia, and I would like to see that question seriously addressed.

Also, the proposal for staggered reserve requirements—having reserve settlements only on banking days and not over weekends and having one-fifth of the banks settle on each bank day of the week would be desirable. That would smooth out the fluctuations in the balances over the week. We wouldn't have the problems of interest rates running up sharply on Wednesdays, or dropping sharply on Wednesdays, as currently is the case.

The question of the discount rate being tied to market rates is not part of the latest proposal and I thought that it was a very good idea and I would like to see it reconsidered at a later point if it is not going to be included at this time. Changes in the discount rates have at most an announcement effect on monetary policy, often, I think, a misleading announcement effect. That thing gets more attention than I think it deserves.

I think the rate should be tied to something like the last couple of weeks' Treasury bill rate, but at a premium. There should be a penalty of, say, 50 points above Treasury bill rates. Then there should be a right to access to the discount window. It should not be a privilege. I think all commercial banks, and I would go so far as to say all financial institutions that issue transaction balances, should have the right to access at the discount window as long as it is at a penalty rate. The purpose is for the central bank to be the lender of last resort in the event of a financial crisis, and I think whether it is a credit union, a savings and loan association, or nonmember commercial bank, large or small, that if they run into clearing problems or financial difficulties, they should have access to the central bank's discount window as long as they are paying a little premium for it and not receiving a subsidy from the taxpayers.

If it is not a right and not a premium—if there is a subsidy because the discount rate is below current market rates—then I think appropriate regulatory authorities for nonmember banks and thrift institutions should have some say-so in the access to the window because, after all, it is the taxpayer's pocket that is involved.

My proposal would be to tie the discount rate to market rates at a penalty and let all institutions, members, nonmembers, and thrift institutions have access to it.

I think I will stop at this point and answer any questions you would like.

[Mr. Jordan's prepared statement follows:]

Statement by

JERRY L. JORDAN

Senior Vice President and Economist
Pittsburgh National Bank

Mr. Chairman and Members of the Committee:

I appreciate this opportunity to present my views on proposed legislation dealing with reserve requirements on transaction-type accounts at financial institutions, the payment of interest on reserve balances, the pricing of Federal Reserve services to private financial institutions, and related questions. I have studied the proposed legislation as well as statements by Chairman Reuss, Congressman Mitchell, Congressman St. Germain, Federal Reserve Chairman Miller, and other witnesses that have appeared before this committee in the past two weeks. In my prepared statement I have not attempted to take a position on each issue that has been raised during these hearings, but I look forward to an opportunity to answer your questions.

The initial part of my statement is directed towards a few basic issues which I believe are important to consider when addressing the general subject of reserve requirements. My views on Federal Reserve pricing of services and on a number of other regulatory issues appear at the end of my statement.

A discussion of the types of deposits and the institutions which are subject to mandated reserve requirements, the appropriate level of reserve requirements, and the question of whether interest should be paid by regulatory authorities on such reserves, should begin with some analysis of the purpose of reserve requirements. I will comment on three possible reasons for having legal reserve requirements.

First, if non-interest bearing reserve requirements are viewed merely as a form of taxation, then a proposal by the central bank to pay interest on reserves is merely a way of reducing this form of taxation. If that is all that is involved -- a desire to reduce this particular form of taxation -- then why not do so explicitly by reducing the level of the reserve requirements?

If the primary purpose of reserve requirements is to impose a tax on institutions, and the reason for having a graduated structure of requirements is to compel larger institutions to pay proportionally more tax (as a result of higher reserve requirement ratios), then it is not at all clear why financial institutions of the same size -- whether they are commercial banks, mutual savings banks, savings and loan associations, or credit unions -- should be subject to different rates of taxation.

Second, if the purpose of reserve requirements is to protect depositors from loss of their funds and to promote the viability and efficiency of the financial system, then an assessment should be made as to the appropriate level and structure of reserve requirements in order to achieve that purpose. There is no evidence that the graduated structure promotes safety and efficiency; there is no evidence that a commercial bank that is a member of the Federal Reserve and subject to a reserve requirement of 16¼ percent on demand deposits over $400 million is safer and more efficient than a similarly sized institution that is not a member of the Federal Reserve System and is not required to hold idle reserves. On the other end of the scale, there is no evidence that an idle cash reserve requirement of 7 percent makes a member institution with $5 million in demand deposits a safer place for a depositor to hold funds than a nonmember institution -- whether it be a commercial bank or a thrift institution that offers transaction services such as NOW accounts, pay-by-phone, or share drafts.

Third, if the purpose of reserve requirements is to enhance monetary control, then the tiered structure of reserve requirements is even less defensible. Not only is there <u>no</u> evidence that a tiered structure of reserve requirements increases the ability of the monetary authorities to influence the level of the money supply, there _is_ some evidence that a tiered structure has made it more difficult to control the money supply than would a uniform structure.

The distinction between uniform and universal reserve requirements is useful. Uniform reserve requirements means that institutions that are subject to reserve requirements on certain types of deposits are all subject to the same reserve requirement ratios and satisfy their reserve requirements by holding the same types of assets. Universal reserve requirements means that _all_ institutions offering a certain type of deposit or account that is subject to reserve requirements by _any_ institution would be subject to the same reserve requirements.

Several issues are involved in assessing whether or not reserve requirements should be uniform and whether or not they should be universal. First is the question concerning the appropriate measures of the nation's money supply that are controlled by the central bank as part of the process of formulating and implementing monetary policy. Both the theoretical and the empirical issues have been addressed in numerous places. The recommendations by the Special Committee on Monetary Aggregates, commissioned by the Federal Reserve and chaired by Professor Leland Bach, are still relevant and worthy of further consideration.

My view is that there should be a new statistical measure that conforms to the theoretical concept that is associated with the narrow measure of the money supply, currently referred to as Ml. It would consist of currency plus all transaction-type balances at any financial institution, regardless of reserve requirements and interest rate considerations. So long as regulation Q type ceilings on time and savings deposits exist and are below market rates on competitive financial assets, all accounts from which transactions can be made directly -- whether they are called demand deposits, negotiable order of withdrawal (NOW) accounts, non-interest bearing negotiable order of withdrawal (NINOW) accounts, share drafts, pay-by-phone, or automatic transfer accounts -- should be maintained separately from time and savings accounts at all institutions. Data on these transaction accounts should be collected from all institutions for inclusion in the narrow definition of money stock (Ml), and the issue of the amount and form of any reserve requirements on them, and any interest rate ceilings on them, should be dealt with separately from any decisions regarding reserve requirements and interest ceilings on non-transaction-type deposits or accounts at all financial institutions.

Accurately collecting and aggregating all transaction-type balances is an essential step towards effective monetary policy management. However, there is disagreement as to whether it is a sufficient step for the conduct of monetary policy. On this question, I believe that the Federal Reserve tries to have it both ways. At one time, such as in the proposed Reserve Requirements Act of 1978, (H.R.13476), the Fed argues that imposing reserve requirements on all transaction-type balances at financial institutions is necessary for control of the money supply. However, in actual practice, the Federal Reserve does not operate on a reserve aggregate concept, such as total reserves or the monetary base, in spite of persistent recommendations to that effect over the past decade.

So long as the Federal Reserve continues to focus on the daily and weekly average Federal Funds rate as an operating target in its efforts to influence the monetary aggregates, the Fed's arguments about the necessity for universal reserve requirements are without merit. If Federal Reserve officials believed their own explanations for past overshoots and shortfalls in the growth of money, or their own analyses about the prospects for money growth in the future, then they should be telling this Committee that the subject of reserve requirements is irrelevant to the way in which they conduct monetary policy.

It is undeniable that all financial institutions will hold some reserve balances -- in the form of both vault cash and idle balances with other institutions for clearing purposes -- even in the absence of legal minimums. I know of no evidence that legal reserve requirements greater than the levels that would be held anyway are necessary for effective control of the money supply. However, it does not follow that the imposition of reserve requirements on transaction balances at some financial institutions, and not at others, does not affect the reliability of monetary control techniques.

Previous studies have shown that under the present system, shifts in balances among different size classes of member commercial banks that are subject to different reserve requirement ratios contribute more to the variability between the money supply and the monetary base than do shifts in balances between member and non-member institutions. Universal reserve requirements would contribute very little to the Federal Reserve's ability to control the money supply if reserve requirement ratios are not applied uniformly.

If minimum idle balance or cash reserve levels at some institutions, such as large member commercial banks, are set above the amount the same institutions would hold in the absence of legal minimums and also above the ratios held by other institutions, then the precision of monetary control is affected. Any shift in balances from institutions with high legal reserve ratios to institutions with low or zero legal reserve ratios releases reserves or high powered money into the banking system which have the potential for a multiple creation of money balances unless offset by open market draining operations. Conversely, shifts in balances from financial institutions that have zero or low reserve requirements to institutions that have much higher reserve requirements absorb reserves and cause a contraction in the amount of money in the economy unless offset by the central bank.

There are seasonal as well as cyclical patterns in the movements of various types of deposits that are different between large banks and small banks, urban banks and rural banks. Consequently, the precision with which the Federal Reserve could control the money supply by operating on total reserves, or the monetary base, depends upon the Fed's ability to forecast and offset the effects of shifts in balances between different types and sizes of financial institutions. That is the situation today, and it would continue to exist even under proposals to extend the tiered structure of reserve requirements to all financial institutions.

I believe that if the objective in making proposals for a change from the present system is to enhance their ability to control the money supply, then the Federal Reserve should be arguing for a single, uniform reserve ratio applied to all balances of the same type. In addition, the Fed's operating procedures should be changed so that total reserves or the monetary base replaces the Federal Funds rate as a short-term operating target.

Statutory reserve requirements, as proposed in the amendments to the Stanton bill, would be desirable if set at a sufficiently low level. I believe a larger amount of transaction balances could be exempted from legal minimums, and I would suggest that something in the range of the first $20 to $30 million of transaction balances should be exempted initially. In these inflationary times, there also should be some provision for indexing that amount over time. However, as previously stated, a graduated scale of reserve requirements, as proposed in the amendment to the Stanton bill, would not be desirable.

I would make two proposals in this regard. The first is that a uniform cash or idle balance reserve requirement of less than 10 percent be imposed on transaction balances at all institutions subject to the reserve requirements. Something on the order of only 6 to 8 percent may be adequate. Second, if there is felt to be justification for imposing higher reserve requirements on larger institutions, then the incremental reserves over and above the uniform base amount should be held in the form of U.S. Government securities. For example, the first $25 million of transaction balances at any institution would be exempt from any legal reserve requirement. From $25 million to $100 million in transaction balances would be subject to a 6 percent minimum reserve that is met by holdings of vault cash and balances at the Federal Reserve. Then for balances above $100 million, possibly on a graduated scale, 6 percent would be held as vault cash or balances at the Federal Reserve and the additional percentage would be met by the institution's holdings of government securities.

At this point, I want to take up the subject of the payment of interest on reserve balances. In principle, I am opposed to any payment of interest by the Federal Reserve on reserve balances. Interest should not be paid on the vault cash held by member banks unless a general form of inflation indexation is adopted wherein all citizens have an opportunity to earn interest on their holdings of currency. In addition, as I stated at the outset, since the imposition of a reserve requirement is a form of taxation, then the payment of interest on reserves is nothing more than a tax rebate and I believe that it would be more desirable to lower the tax rate rather than to maintain high tax rates and grant rebates.

Federal Reserve officials have argued that their authority to change the level of reserve requirements is necessary for monetary policy purposes. I agree with the arguments and questions put forth in the July 27 statement by Chairman Reuss to the effect that there is no evidence to support such a contention. Consequently, I have no trouble supporting the proposal for statutory reserve requirement ratios.

At this point I would like to state my position on a few more issues related to the subject of reserve requirements. No matter what the outcome of deliberations regarding the level, the uniformity, and the universality of reserve requirements on transaction balances, I do not see the necessity nor the desirability of any legal reserve minimum on time and savings balances at any institutions. Furthermore, U.S. Government balances at commercial banks, known as Treasury Tax and Loan accounts, are not part of the money supply and there is no reason to impose reserve requirements on them. Fluctuations in the Treasury's balances absorb and release reserves in a very erratic manner and influence the relationship between total bank reserves, or the monetary base, and the money supply. This serves no useful purpose.

On another issue regarding the subject of reserve requirements, I do not believe that the present system of lagged reserve requirements is desirable. There is empirical evidence suggesting that such a system reduces the ability of the Federal Reserve to control the money supply, and I would urge a return to a system of coincident reserve requirements. In addition, the proposal to stagger settlement dates within the week would be desirable.

Turning to the subject of the discount rate, I support the amendment to the Stanton bill which would tie the discount rate to the average Treasury bill rate over the past two weeks. However, I would suggest that the discount rate be specified at a premium over the average Treasury bill rate in order to eliminate any subsidy at all during periods of rising interest rates. Specifically, the discount rate should be pegged at one-half percentage point (50 basis points) above the average Treasury bill rate.

Finally, on the subject of the pricing of Federal Reserve System services, I agree with the Stanton bill that the prices of Federal Reserve services should be set at competitive market levels. I think that it is necessary for the efficient allocation of resources that the Federal Reserve impute a cost of capital that is at least equal to the average interest rate on outstanding government debt, and that they also impute a corporate income tax rate in setting their prices. I also agree with Congressman St. Germain's concern about the range of Federal Reserve services that are provided, and I believe that competitive market pricing by the Federal Reserve would help to determine which services private institutions can provide at least cost and which ones must carry a subsidy from Federal taxpayers. In general, I believe in the proposition that a government agency, such as the Federal Reserve System, should provide only those services that the private market system cannot or will not provide.

In conclusion, I agree with much of the Federal Reserve System's analysis as it appears in Chairman Miller's statement, regarding the problems of maintaining the present system, but I do not agree with the Fed's prescriptions as to what to do about it. I hope that the outcome of these hearings will be legislation that makes it possible to more accurately measure and control the nation's money supply, and that the amount and form of reserve requirements which are imposed are only those which are necessary for effective formulation and implementation of monetary policy.

Mr. MITCHELL. Thank you very much for some very interesting recommendations.

Mr. McCracken.

STATEMENT OF PROF. PAUL W. McCRACKEN, EDMUND EZRA DAY UNIVERSITY PROFESSOR OF BUSINESS ADMINISTRATION, UNIVERSITY OF MICHIGAN

Mr. McCRACKEN. Thank you, Mr. Chairman. I appreciate this opportunity once again to appear before this committee.

I am not going to read the statement which I submitted earlier. I am going to submit an amended version of that in view of the developments of the last several days.

As I understand the items in the new bill which you outlined in your opening comments, I find myself generally quite sympathetic with it and if I were a member of this committee, I suspect I would vote for it. It seems to me the basic elements that have been proposed here constitute a substantial step in the right direction.

Obviously the capacity to expand and improve our economic information system in this area is highly desirable. One of the impressive things we have seen historically is the magnitude of revisions which frequently are made and which leave us with the conclusion that not only are we not sure where monetary policy ought to go, but at the point at which decisions had to be made we weren't even sure where it had been. Anything that can be done to improve this would obviously be desirable.

On the question of imposing lower and uniform reserve requirements on what Mr. Jordan has called reservable liabilities, that strikes me also as a significant step in the right direction.

These very wide ranges within which decisions can be made are probably more comfortable from the standpoint of the regulatory authorities, but, on the other hand, wide ranges for targets also tend to make for sloppy management of policies.

After all, if the target is big enough, it is not very easy to miss it, but it is not very significant either.

I would like to expand a bit on a point which Mr. Schechter made at the end of his comments. Mr. Jordan also alluded to it in a slightly different connection. Having a half a percentage point up or down would not trouble me. I don't think it is a very significant thing. It is not, however, really directed at the kind of leeway which ought to be central to changes in reserve requirements.

I do not see changes in reserve requirements as having any significance in the ongoing management of monetary policy. It is hard to conceive of any situation where open market operations could not handle what might be achieved by a half a percentage point one way or the other.

On the other hand, Mr. Schechter did allude to potential situations where there would need to be some authority. Suppose you get major changes, which can occur rather suddenly. He alluded to the problems we faced in certain panic situations.

I would point out also that in the thirties we had a problem the other way around. We had a situation there for a while where for every dollar of required reserves member banks had more than $1 of excess reserves.

I, of course, have had no opportunity to study the language of the new bill, so it may be there, but I should think the Federal Reserve ought to have the authority, perhaps for a limited period until the Congress could review the matter, to alter in a major way the reserve requirements. Suppose there were an international crisis and we had a massive inflow of funds from abroad, such as we had in the thirties, which produced the sloppy reserve situation at that time.

That is the kind of a situation in which, it seems to me, authority to alter in a major way reserve requirements ought to be given.

On the proposal to exclude the first $100 million of these reservable liabilities, in principle having some kind of lower limit exclusions strikes me as making sense.

I have not examined this in detail. I would have no opinion on that specific issue.

As I understand it—and once again this may be erroneous—that $100 million is to be indexed by the rise in nominal GNP, not the price levels.

I think I would suggest to the committee that the escalator for this indexing be the price level and not nominal GNP. A part of the expansion in the economy in nominal terms will be taken care of by an expansion in the deposit liabilities of existing institutions, but a part of it ought to be taken care of by the gradual growth in new institutions, as we have seen in the last 25 years.

I should think the primary objective of this kind of an escalator ought to be particularly in this era of uncertainty about the price level, to make sure that that $100 million is kept intact in real terms and not, as it were, seeming to signify that each of the existing institutions ought to have a proportionate share of the growth in the economy. It is not a major point, but I think there is a logic there which would deserve some further consideration by the committee.

The suggestion that all banks have access to the discount window certainly is a sensible provision in the bill.

I also like the idea that regulatory authority—and I assume examination authority—would remain in, I suppose, the State banking authorities and the FDIC and so forth.

I think this is important. Our kind of pluralistic system still contains a great many advantages. I don't believe in monopoly where we can avoid it, and I think there is some desirability in not having the central bank have a total monopoly of these matters.

I realize that in a very early incarnation in my career I was at the Federal Reserve Bank in Minneapolis, and there I tended to see it the other way around, but now I am speaking as a citizen.

Now, in conclusion, I would suggest to the committee that it keep on the agenda of unfinished business a further exploration of the proposal to extend reserve requirements to the transactions balances of all institutions; not just all commercial banks.

I think the intramarket competition situation as between banks and other institutions and the inequities that have been involved there are substantial. That problem is substantially reduced by reducing reserve requirements, so the problem is becoming less urgent.

However, if we look at the relationship between changes in economic activity and monetary changes, it is interesting to note that just in a purely statistical sense, it is changes in M_3 which are most closely associated with changes in gross national product, not changes in M_1 or M_2. In fact they array themselves in reverse order—M_3, M_2, M_1.

This suggests that if our quest here is to modify our current procedures in order to provide for more effective execution of monetary policy, it may well be that at some point we ought to consider extending reserve requirements not only to all commercial banks, but to financial institutions more broadly.

On the question of paying interest on reserve balances, in general I would be sympathetic with that. I think it makes sense.

If we were to carry on with the very high reserve requirements we have had, I would consider it an urgent matter. If we move to much lower reserve requirements, then the issue also becomes less urgent.

I do not see in principle the logic of imposing reserve requirements on certain institutions for monetary control purposes and not on the liabilities of other institutions when the statistical evidence suggests that those monetary liabilities are just as pertinent to the proper management of monetary policies as the reservable liabilities of the commercial banks themselves.

I think you are coming up with a bill which will make the situation better. I would also suggest that the committee consider that there is unfinished business here which requires further consideration at an appropriate time.

Thank you very much.

[Mr. McCracken's prepared statement follows:]

PREPARED STATEMENT OF PAUL W. MCCRACKEN, EDMUND EZRA DAY UNIVERSITY PROFESSOR OF BUSINESS ADMINISTRATION, UNIVERSITY OF MICHIGAN

Mr. Chairman. I appreciate this opportunity to appear again before the House Committee on Banking, Finance and Urban Affairs—a committee before which I have appeared many times both as a government official and as a private citizen.

In his remarks before the House on July 14 the Chairman of this Committee described the matters before you this morning as "legislation to enhance the efficiency and competitiveness of our financial system and improve the conduct of monetary policy." He did not, I believe, over-state the importance of this legislation. There is needed work to do in these areas, and it is important that some legislative action be taken. There are, I believe, two reasons for the urgency of action. For one thing the empirical evidence is increasingly persuasive that the basic path for monetary expansion is also the path along which the economy will also move. During the last five years the simple ratio obtained by dividing GNP into the more broadly defined money stock (M_3) two quarters earlier has averaged 64.9 percent. And for only one of the 20 quarters during this period did this ratio fall outside a range of one percentage point on either side of this average. (The ratio was 63.6 percent in the third quarter of 1975 when there was a problem of monetary dehydration.)

As one examines the track record for the results of monetary policy, it is also clear that the technology of managing these policies needs improvement. These matters have been discussed before your committee many times and require no further belaboring here. It is a fact, however, that rates of monetary expansion have on occasion been erratic—with the result that a major instrument of economic stabilization has itself been a source of economic instability. While central bankers, in spite of the awesome edifices within which most societies house them, are ordinary mortals and like the rest of us make their full quota of mistakes in judgment, the frequency with which they miss their own targets suggests that there are some institutional and structural problems needing attention. It is also pertinent to this legislation to note that the money stock whose changes, in the technical statistical sense, best explain changes in GNP is M_3—not the more narrowly defined M_1 or even M_2.[1] We cannot ask the Federal Reserve to manage a more steady expansion of this broadly defined money supply and at the same time leave almost half of it outside the ambit of Federal Reserve management.

Second, Mr. Reuss was correct in his concern about the efficiency of the financial system. In a sense all financial institutions are intermediaries by which flows of funds from savers are put to work in our economy. Inefficiencies in any industry are a legitimate matter of concern, of course, but in our financial system and its institutions inefficiencies and distortions can exert in subtle and pervasive ways a magnified effect in producing misallocations of resources. And the pricing system is the sophisticated communications network by which signals are given to use more of this or less of that. When the pricing system is immobilized or circumvented, and resources are allocated by decree or cajolery or sermon or regulation, the results are apt to be at best sub-optimal. That has been a clear lesson of history, and it is all at least as applicable to our financial system as to other segments of the economy.

Let me turn now to the specifics of the proposed legislation. The Federal Reserve's proposal to extend reserve requirements to all transactions deposits deserves affirmative action, and I would support it. Differentiation of reserve requirements according to type of deposits rather than type of institution has always made sense to me. Such deposits as NOW accounts will certainly be merchandised as de facto checking accounts, and they ought to be subject to the reserve requirements pertinent to such deposits. Whether that deposit, which is de facto a checking account, is in the Chase Manhattan Bank or the Ann Arbor Credit Union makes no difference in terms of the appropriateness of imposing reserve requirements.

The suggestion of exempting, say, the first \$10 million or so of deposits from reserve requirements probably makes sense as an administrative convenience. It is not, of course, justified as a means of strengthening the competitive position of small banks.

Indeed, customers are apt to have far more alternatives in financial markets served by large banks (and availability of alternatives is the operational meaning of competition) than in markets served by small banks—where a bank may be the only financial institution really available to customers.

Narrowing the range of the reserve requirement percentages, within which regulatory discretion can be exercised, is a sensible move. If the range for reserves against demand deposits should be as wide as from 7 to 22 percent, or for other transactions balances from 3 to 12 percent, there is a real question as to whether there should be limits at all. The infrequency with which reserve requirements have in fact been changed historically suggests that these limits could be narrowed substantially.

This tendency for agencies to lean toward wide ranges of discretionary authority is understandable, but it should be resisted. If the target is wide enough, it will certainly not be missed, but what hitting the target means is then consistent with widely varying outcomes. The present target of a 7½ to 10 percent per year rate of growth for M_3, for example, on a sustained basis would at the low end establish the basis for a 4 percent per year rate of inflation, and at the high end a price level rising at 6½–7 percent per year. A target to be meaningful should be one figure, with the common sense understanding that there will be moderate short-term variances around that target.

Wide ranges for targets, in short, are apt to mean sloppy management of policies.

It is, of course, well to keep in mind that historical discontinuities do occur, and the management of policy must have the capability to adapt to them. In the 1930's, for example, member bank reserves expanded so rapidly that for every dollar of required reserves member banks had more than a dollar of excess reserves. It might, for example, be prudent for the Federal Reserve to have the authority—with perhaps the affirmative vote of, say, five members and a report to the Congress on the findings leading to the action—to go outside the narrowed range of their normal reserve requirement for limited periods.

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[1] If changes in GNP in the current quarter are expressed as a function of changes in the money stock—i.e., $\Delta GNP_t = f(\Delta M_{t-1}, \Delta M_{t-2}, \Delta M_{t-3})$—the coefficient of determination using M_3 is 0.63, substantially above the 0.56 for M_2 or 0.36 for M_1. This means that changes in M_3 in the three prior quarters explain in the statistical sense 63 percent of the changes in GNP. These results come from a study by my research assistant, Harry Wang.

Naturally the proposal for more effective information and statistical systems is to be supported, and it is not a minor matter. Wide differences between preliminary and final data mean that at moments of decision we do not even know where we have been—let alone where we are going.

The proposal to apply the pricing system to Federal Reserve operations and services is a particularly significant feature of this legislation. When an incremental or additional cost of an incremental use of resources is zero to the user, it should come as no surprise that the usage will then be high. Moreover, this then puts the institution offering "free" resources in the position of a monopolist, and monopolies whether the U.S. Government Printing Office, the Postal Service, or the Federal Reserve are apt to behave like monopolists—such as inadequate pressures to reduce costs, or resistance to innovation.

Federal Reserve charges for such services as shipments of coin and currency, check-clearing, and security safe-keeping are, therefore, to be applauded. It is, of course, important that the charges be explicit, and that they reflect a full accounting of costs including profits. The necessity for earning profits on capital utilized is the discipline our economic system imposes on users of capital resources to force economic utilization. If other institutions find ways to perform these services for society more economically than the Federal Reserve, they should not be prevented from doing so by some kind of social subsidization of the central bank. Moreover, there will then be more possibility for innovation—something in short supply now in the American economy.

If applying the pricing system is an effective discipline for encouraging the economic use of resources, it should be fully applicable to those financial resources used as reserves on deposit at the Federal Reserve Banks. Others must, of course, speak to the legal aspects of this issue. If there is uncertainty about the scope of the Federal Reserve's present authority on this matter, it would seem desirable for the Congress itself to act. I would, in short, share the position of the Committee's Democratic Caucus in its resolution of June 26.

On the substance of the proposal for the Federal Reserve to pay interest on reserve balances the decision to pay interest should be clean cut. If these balances are economic resources which the Federal Reserve needs to use, the Federal Reserve should pay the full economic cost, and a good proxy for that cost or price is the Treasury bill rate (though a case could actually be made that these are long-term commitments and should carry a higher rate more pertinent to long-term obligations). The proposal to pay interest equal to some segment of Federal Reserve earnings, or equal to some percentage of total earnings, markedly weakens the case for any action here at all. It is no longer consistent with the logic of using the pricing system, since such limitations would be a form of price control. Moreover, the economic incentive to keeping reserve balances at the Federal Reserve Banks would be sharply reduced since owners of these balances would be paid uncertain returns with no necessary relationhip to market conditions.

The incremental cost of adopting the clear-cut policy of paying market rates on these reserve balances, this additional cost being the major rationale for the awkward limits suggested for these payments, is probably over-stated. If the market works toward equilibrating rates of return on capital employed in different enterprises and industries, with due regard for differences in such factors as risks and rates of growth, the additional earnings on their reserve balances could be expected to be offset by lower earnings on other assets as financial markets become fully adjusted to the altered situation. The net increase in cost to the Treasury would thereby be correspondingly limited.

Procedures to phase in these new arrangements gradually, of course, make sense. If the cost is there, however, it should in the interest of efficiency and also inter-institutional equity be made explicit.

Users of economic resources, including Government, should pay the going price. If the resulting gain in economic efficiency were as much as 0.02 percent, there would be a net gain for the economy.

In summary, these matters are important. Your Chairman is correct that the orderly conduct of monetary policy and the efficiency of our financial systems do warrant appropriate attention by the Congress. If these proposals deal with matters of that importance, and I believe that they do, then the Congress would be well advised to carry through fully on the logic of their premises.

Mr. MITCHELL. Thank you very much, Mr. McCracken.

Mr. Mayer.

STATEMENT OF THOMAS MAYER, PROFESSOR OF ECONOMICS, UNIVERSITY OF CALIFORNIA AT DAVIS

Mr. MAYER. Thank you, Mr. Chairman. I appreciate being allowed to testify on these important issues.

The information requirement in the new bill strikes me as very good and useful and I would like to associate myself with Mr. Jordan's comment that it ought to be able to handle nonmember banks.

The definition of reservable liabilities to include overnight funds is also very desirable.

The exemption for small banks from the reserve requirement and the imposition of the Fed reserve requirements on large nonmember banks seems to be a very good compromise between the Fed's fear of losing banks and the fear of other people that the Fed is engaged in trying to extend its power too much. The exemption of small banks does not create any serious problem.

With regard to the level of the reserve requirement, there are several aspects to this.

First, there is the reduction in the existing tax which now falls on banks and their customers, and it seems reasonable to cut this excise tax. With regard to controlling the money supply and monetary policy, a new reserve requirement may create some difficulty. The difficulty arises in the following way: If we think of banks as wanting to keep very low reserves for their own purposes, say 2 percent, then cutting the reserve requirement to 6 percent doesn't really create a problem. But there is now some evidence in an unpublished paper by Professor Kane of Ohio State University which suggests it may be the case that banks want to keep more reserves than that. He feels that on the whole banks would want to keep approximately the reserve requirements they have from the Fed on demand deposits, but want lower reserve requirements on time deposits.

If this is due to pressure from correspondent banks, it wouldn't create a problem.

But suppose it is due to the fact that banks, for their own business purposes, want to keep, say 8-percent reserves and have a 6-percent reserve requirement. This is essentially the same thing as repealing the reserve requirement. This is a very major change. Insofar as banks want to keep a steady 8 percent for their own business purposes, there is again no problem, but it is possible that what banks want to keep as reserves would vary from time to time in a way difficult to predict, so that sometimes they may want to hold 6 percent, sometimes 10 percent. That would then greatly complicate the task of the Federal Reserve. It could turn out to be a serious problem, particularly in the beginning when the Fed does not really know what reserves banks are going to be keeping because they may be keeping more than intended. Consequently, we should ask the FDIC to do a quick study of this, if necessary, only by making a few phone calls to banks to find out what their own policy would be.

Turning to the same reserve requirement for the demand deposits and time deposits, this is in line with the tendency now to merge demand deposits and time deposits. Perhaps we should go further, however, and allow the payment of interest on demand deposits too. The market in any case will eventually bring this about.

Having equal reserve requirements on time deposits and demand deposits probably makes M_2 more predictable than it is now. One can't be sure of this, but probably it does. Again, the Fed could probably very quickly run a simulation on that. M_1 is probably made less predictable.

As far as the impact on the economy is concerned, it depends on the extent to which the public raises its expenditures by as much for a dollar of demand deposits as for a dollar of time deposits in its portfolio.

In any case, the Federal Reserve is now planning to allow banks to transfer automatically from time deposits to demand deposits, which largely eliminates the distinction between the two. Professor Hart has submitted to the committee a memorandum where he points out what a major change this would be and the serious problems that it could create.

One final aspect on the equal reserve requirement: If Professor Kane is right, and banks want to keep high reserves against demand deposits, but not against time deposits, they will be unhappy with having to keep 6 percent against both, which roughly doubles their reserve requirement on time deposits.

Furthermore, if we are to have reserve requirements on time deposits in commercial banks, it is hard to justify not having reserve requirements for transaction accounts in nonbank institutions, things like NOW accounts, etc. These things are money much more than time deposits are. I would strongly urge the committee to consider including these things. If they are to be included eventually, this should surely be done now before various institutions get into the business of having NOW accounts, and then say later on, "Well, we started our activities in this area on the assumption that there would be no reserve requirements." That would probably be a problem.

We have in this bill a solution to the problem of nonmember banks, at a time when the real problem for monetary control may not be the absence of reserve requirements on nonmember banks, but the absence of reserve requirements. Federal Reserve requirements that is, on savings and loans and mutual savings banks, etc.

Turning to reducing the discretion the Fed has to change the reserve requirement to half a point either way, that is a very good thing. The Fed does not need this power. It is a power to tax. The Treasury does not have the right to change taxes on its own. Why should the Federal Reserve?

I am sorry to see the automatic adjustment of the discount rate go out. It is not in the new bill. I presume that is done to leave the Federal Reserve flexibility, but actually the Fed does not have much flexibility with the discount rate in any case, because it is under great pressure not to raise it and if you can't raise it you also can't lower it.

What may be a good compromise, therefore, is perhaps telling the Federal Reserve that it should keep the discount rate in line with, or somewhat above, open market rates, so that the Fed would still have some flexibility here and would be able to use the flexibility to raise the rates by saying, "We will have to raise the rate because the law tells us to keep it in line with market rates and not to subsidize banks by a lower rate."

Access to the discount window for all institutions seems highly desirable to me. Thank you.

[Mr. Mayer's prepared statement follows:]

STATEMENT OF THOMAS MAYER, PROFESSOR OF ECONOMICS, UNIVERSITY OF CALIFORNIA AT DAVIS

The Committee is considering three sets of related proposals: a bill by Congressman Stanton, some proposals made by the Federal Reserve, and certain amendments to the Stanton bill introduced by Chairman Reuss. I welcome and appreciate the opportunity to be allowed to testify on these important issues. Congressman Stanton's bill consists of three parts: the payment of interest on member bank reserves, the pricing of Federal Reserve services, and the initiation of a Federal Reserve study on the feasibility of allowing banks to keep their reserves in the form of government securities. I will discuss Congressman Stanton's bill first, then the Federal Reserve's proposals to impose additional reporting requirements, and to turn over to the Treasury some funds out of its surplus, and to impose reserve requirements on transaction accounts, and then Chairman Reuss' proposals to eliminate the Federal Reserve's control over the discount rate and the reserve requirement.

GOVERNMENT SECURITIES AS RESERVES

The idea of having banks hold their reserves as government securities instead of Federal Reserve deposits and currency is interesting, but it might be useful to make it more specific. There is an immense difference between allowing banks to hold as reserves mainly regular government securities which they could buy on the open market, and allowing them to hold only special government securities issued specifically for this purpose. In the latter case, if banks could count as reserves, only these securities, and not deposits with the Federal Reserve and currency, monetary control might well be enhanced since it would immunize the reserve base against market factors that can now change it, such as fluctuations in currency in circulation, or in Treasury deposits with the Federal Reserve. But in the former case—if the security reserves are supposed to be the binding part of the reserve requirement—monetary control would be weakened since banks could then readily obtain any reserves they want by buying government securities on the open market. The Federal Reserve should therefore be told to not exclude from its study the use of special issues of government securities as reserves.

THE PRICING OF FED SERVICES

Another part of the Stanton bill would require the Fed to price its services to member banks explicitly. This is also one of the Federal Reserve's proposals. Since there is also no reason why the Fed should have a monopoly in providing these services, pricing them separately from Fed membership is highly desirable since private firms can then enter the market, and try to offer these services at a lower price.[1] Of the two proposals I prefer the Stanton version to the Federal Reserve's. The latter does not have an explicit provision to include in the price of the services an allowance for the cost of the required capital and the taxes that a private firm would pay. Hence the Fed could price its services lower than a private firm could, even if the private firm is more efficient. Another way in which the Fed proposal, unlike the Stanton bill, would discourage the entry of private firms is that it leaves the Federal Reserve the flexibility "to alter charges or service policies in order to meet its responsibilities to maintain satisfactory, basic levels of services for the nation as a whole and to encourage innovations."[2] The possibility that the Fed would on this basis suddenly lower its service charges below cost could well discourage private firms from undertaking the investment that is required to enter this market. The Stanton bill is therefore much more likely to encourage competition in providing these services, and is preferable on this score. And if there is a real need for the Fed to lower its service charges below costs, legislation to permit this could always be passed.

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[1] Moreover, Beryl Sprinkel has pointed out in his testimony that if the Federal Reserve services are, at the margin, free to banks, banks will use them excessively.

[2] Board of Governors, Federal Reserve System, *Press Release,* July 10, 1978, p. 5.

INTEREST ON REQUIRED RESERVES

But the most important part of the Stanton bill is the payment of interest on reserve balances. This is also provided for in the Fed's bill, and would be reduced below the level of the Fed's proposal by the Reuss amendment. As long as the reserve requirements are the same, and apply to the same set of institutions, the payment of interest on required reserves can have, at most, a trivial effect on the efficacy of monetary policy.

Whether or not to pay interest on required reserves is an issue of fiscal policy rather than monetary policy. Requiring banks to hold reserves that do not pay interest is equivalent to forcing banks to make an interest-free loan to the government. This is brought out by considering what would happen if instead of facing a reserve requirement the banks would be required to hold Treasury securities that pay no interest. Clearly, apart from the fact that banks would then have to hold other reserves, both the banks' income and the Treasury's income would be the same as it is now when banks hold required reserves, but do not obtain a piece of paper, called a bond, in exchange for their reserves. Another way of seeing this is to consider what happens when a new bank deposits, say, $1 million as reserves with the Federal Reserve. The Fed uses these $1 million to buy a government security earning, say, $50,000 which then, at the end of the year, it turns over to the U.S. Treasury. Hence, the bank is, in effect, taxed $50,000.

Since the reserve requirement is, in effect, an excise tax, it should be evaluated by the criteria that are used to judge excise taxes. One major criterion is the incidence of the tax. In the first instance the reserve requirement is a tax on banks, and initially bank stockholders would gain if this tax were removed. But most, though certainly not all, member banks operate in a more or less competitive market. Hence, in the long run competition would force banks to distribute these gains to their depositors, borrowers and employees. As far as depositors are concerned, some admittedly old (1962) data suggest that that part of the reserve requirement that is an implicit tax directly on household deposits is progressively distributed. On the other hand, since firms that borrow from banks presumably in large part pass forward in their prices the interest rate they have to pay, that part of the tax that banks pass on to their borrowers is probably distributed more or less proportional to disposable income or is only moderately progressive. All in all, the distributional effects of the implicit excise tax on bank deposits does not provide a persuasive argument for this tax, though in this respect it probably does not differ much from some of our other excise taxes.

Like practically all taxes the implicit excise tax on bank customers has distorting effects on the way resources are allocated. Specifically, it lowers the de facto interest payments that banks make to their depositors by providing them with free services. As a result, depositors reduce the amount of deposits they hold, and hold currency and other liquid assets instead.[3] This is inefficient. For example, suppose that a bank, in the absence of the implicit tax on deposits, would pay the depositor, say, $50 interest, but that because of the tax it pays the depositor only $45. If the depositor gains, say, $48 in terms of convenience by holding currency rather than a deposit, he or she will not keep a deposit. But had the bank been able to pay the full $50, he or she would have opened the deposit and been better off by $2. Since there is some empirical evidence suggesting that deposit holdings are responsive to interest rates, the reserve requirement does, in this way, impose some welfare loss on the economy. And a similar argument applies to a potential borrower deciding whether to borrow from a member bank or some other institution, such as a nonmember bank or a savings and loan association.

Moreover, large American banks compete with foreign banks, both in the United States and abroad, and the existence of a reserve requirement puts them at a comparative disadvantage vis-a-vis these competitors. Specifically, it provides an incentive to large depositors and borrowers to shift their transactions outside the United States into the Eurodollar market. The interest rate paid on Eurodollar deposits is higher than the interest rate paid on large domestic CD's, primarily because banks escape the reserve requirement on Eurodollar transactions. At the same time, U.S. branches of foreign banks can pay somewhat more on their CD's,

[3] However, a reduction of one free service, free clearing of checks, may induce some depositors to hold larger deposits so that they avoid service charges. This results from the fact that previously they earned nothing on their marginal deposit because they did not have a sufficient volume of activity in their accounts to use up all the free services earned. But even in this case resource allocation is distorted.

or lend at a lower interest rate because they too escape the Federal Reserve requirement.

And beyond these economic considerations there is another way in which the implicit tax imposed by the reserve requirement is a very bad tax. Taxes should be out in the open where people can see them. But it is hard to imagine a tax that is more hidden than the tax that results from the reserve requirement.

Thus, the standard considerations by which an excise tax is evaluated suggest that the Federal Reserve should pay interest on required reserves, rather than taxing banks and their customers in this way. And this is powerfully reinforced by the fact that the Federal Reserve System is losing member banks because of the burden of the reserve requirement. It may lose them at a much more rapid rate in the future, both because the spread of items like NOW accounts may cause banks to try to protect their profits by leaving the System, and also because of a demonstration effect. One major advantage of Federal Reserve membership is prestige because the large banks usually belong. But some relatively large banks have been leaving the System in recent years, and this may indicate to other large banks that they can leave too without losing prestige. This sort of thing could easily snowball. And if banks leave the Federal Reserve System this may affect the Fed's control over the money stock, and, of course, also the revenue the Treasury obtains from the implicit tax on banks. I will take both of these issues up later on.

On the other hand, there are a number of factors that suggest that the implicit tax should perhaps be kept. One is that in the short run the stockholders of member banks would receive a windfall gain if the implicit tax were removed. One could well argue that since they mostly bought their bank stock at a price that reflected the existence of this tax there is no reason why they should now be benefited by removing the tax. On the other hand, the price at which they bought their stock should have reflected, at least to some extent, the possibility that at some future time interest will be paid on reserves. This might lead one to argue that there is nothing inequitable about stockholders succeeding in their gamble, and now receiving such a windfall gain. It is not clear to me which of these two arguments is the better.

Second, as long as banks are prohibited from paying explicit interest on their demand deposits, and limited by Regulation Q on the interest they can pay on time deposits, competition among them is relatively inefficient. Suppose, for example, that the implicit tax is removed, and that banks now compete for deposits by offering more free services and gifts, more convenient branches, etc. An efficient bank would already previously have offered its customers all the "free" services and conveniences they are willing to pay for. If they are now driven by competition to offer even more free services these services will be worth less to the depositors than their cost to the bank.[4] In other words, since banks cannot compete by price (interest on deposits) some value gets lost if banks transfer to their customers some of the income they obtain from the Federal Reserve paying them interest on their reserves. However, this is much more of a problem with household deposits than with business deposits. Business firms require many bank services, and, in addition, borrow frequently enough from banks so that banks can pay them implicit interest on their deposits by charging them a lower interest rate on their loans. The case for paying such interest would therefore be substantially strengthened if the regulations that prohibit banks from paying interest on demand deposits, and limit the interest they can pay on time deposits, were removed.

Also, as far as households are concerned, the implicit excise tax on deposits is at least partly offset by another tax consideration. This is that the imputed income a household obtains by holding a deposit is not taxed.[5] For example, consider a person who has a choice between obtaining $5 of interest income by opening a savings and loan deposit, or no explicit, and hence taxable, income but a lot of convenience by holding a demand deposit in a member bank instead. If this person is in the 40 percent tax bracket, the $5 of interest income is worth only $3, and hence he or she may hold the demand deposit instead, even if the added

[4] This is so because the utility someone receives from one additional unit of the bank's free service declines as he or she obtains more and more units of this service. On the other hand, the bank's cost of providing these services is not likely to decline as it provides more of them.

[5] The free services received by a firm are taxed indirectly because they raise the firm's profits, and hence its taxes.

convenience of a demand deposit is worth only $4. The reserve requirement, by imposing a cost on the bank, and hence ultimately on the depositor, helps to offset some of this tax-induced bias towards holding demand deposits, and causes depositors and nondepositors to be treated more equally.

A more important consideration is, however, that if the imputed tax on bank customers is reduced or eliminated some other tax will have to be raised, or some government expenditures cut, or else the deficit will increase. While, as discussed above, the imputed excise tax on bank customers is undesirable, both on grounds of equity and resource allocation, the same is true of other taxes.

Hence, to a large extent, the question of paying interest on required reserves should be decided by comparing the benefits of elimination or cutting this tax with the benefits of cutting some other tax or the loss from cutting government expenditures or raising the deficit. I will not even attempt to make such a comparison in the general case, but I would like to suggest that if, realistically, the only way a reserve requirement can be imposed on transactions balances in nonbanks and on deposits in nonmember banks, is to pay interest on reserves, then I believe such interest should be paid. The case for paying interest is also greatly strengthened if the prohibition of interest payments on demand deposits and the Regulation Q ceiling on time deposits are removed.

If interest is to be paid on reserves, how high should the rate be? In part, the answer depends on how one evaluates the above arguments, for and against; paying any interest on reserves. But it also depends on two other considerations. One is the impact of the implicit tax rate on Treasury revenue. As the Federal Reserve has pointed out, the fact that this tax is causing banks to leave the Federal Reserve System means a continual reduction in Treasury revenue. And if the tax were lowered fewer banks would leave. Hence, there is some implicit tax rate that maximizes Treasury revenue, and it *may* be the case that by paying some interest on reserves Treasury revenue is actually enhanced in the long run. Unfortunately, there is no way of determining empirically whether payment of some interest on reserves would raise long run Treasury revenue in actuality, and if so, what rate of interest would maximize it. But the possibility that paying some interest on reserves would be beneficial to the Treasury cannot be dismissed as unlikely.

A related consideration is that the higher the rate of interest that is paid, the greater will be the proportion of total bank deposits that remain subject to the Fed's reserve requirement. The extent to which this is desirable is discussed below. But again, no data exist that would allow one to estimate the impact of a, say 2 percent interest rate on reserves on the proportion of total bank deposits that are in the Federal Reserve's member banks.

Second, equity suggests that banks be paid interest only to the extent that the legal reserve requirement actually imposes a cost on them. But a considerable proportion of the reserves that member banks hold are reserves that they would want to hold in any case. Estimates of this proportion vary substantially; while one study sets it at one third, another suggests that it is close to 100 percent for demand deposits, though not for time deposits.[6] But the Fed's reserve requirement imposes a burden on member banks even if it actually happens to be the case that member banks want to keep a reserve ratio as high as the one required by the Fed's regulations, because of the form in which the reserves have to be held. Most banks prefer to hold their reserves mainly as balances with their correspondent banks to obtain the free services correspondent banks provide as a quid pro quo. But since member banks must keep their reserves with the Federal Reserve, or as vault cash, they lose this potential benefit from holding reserves. The extent of the loss depends upon how useful these free services are to the banks; that is, the extent to which banks can get around the prohibition of interest payments on demand deposits. Unfortunately, no data are available on this, and I do not know any estimates of even the order of magnitude. But presumably, at the margin, the free services that banks obtain from their city correspondent banks are worth at least slightly less to the bank than the prevailing rate of interest. Hence, even if it is decided to repeal the imputed tax on banks and bank customers entirely, the interest rate paid on required reserves should be at least somewhat less than the rate on Treasury bills or other highly liquid instruments.

[6] For a discussion of some estimates see John Paulus, "Burden of Federal Reserve Membership, NOW Accounts, and the Payment of Interest on Reserves," unpublished paper, Board of Governors, Federal Reserve System. See also Edward Kane, "The Federal Reserve's Membership Problem: A Study in Voluntary Association," unpublished manuscript.

THE REPORTING REQUIREMENT

The Federal Reserve proposes that all depository institutions be required to provide it with information on their deposits and reserves. Chairman Reuss proposes an amendment that would have the Fed obtain this information through other regulatory agencies to reduce duplication. In either the Fed's or Chairman Reuss' version such a requirement is highly desirable. Given the importance that the money supply has for employment and prices it is almost scandalous that, as shown by the substantial subsequent revisions, our early estimates of the money supply are so inaccurate. While much of this inaccuracy is due to difficulties in seasonal adjustment and hence unavoidable, a significant part of the error is due to insufficient reporting by nonmember banks. And as transactions accounts in nonbank institutions continue to grow the infrequent reporting of nonbanks will become a more serious problem. Hence, despite the fact that many Federal reporting requirements are an undesirable and frequently unnecessary burden on business, I believe that the Federal Reserve should be given the power to obtain, either directly or indirectly, reports on deposits and reserves.

In fact, I believe that the Federal Reserve's proposal does not go far enough, that apart from deposits and reserves the Fed should also have the right to obtain, perhaps through the FDIC, information on something else. This is Transaction in Immediately Available Funds.[7] In recent years banks have found a way of avoiding the prohibition of interest payments on the demand deposits of their large customers. One way they do this is that the bank and the customer have the following agreement: at the end of the business day the bank will take all the funds in the customer's account above an agreed-upon minimum, and invest them by having the customer automatically buy securities held by the bank, with the bank agreeing to buy these securities back the next morning.[8] By such repurchase agreements, the customer's deposit is wiped out overnight, but restored the next morning in time to meet any checks that come in. Thus, these funds, although invested overnight, still effectively function as part of the money supply. But when the banks report their deposits to the Federal Reserve, these funds that are invested overnight are excluded, since deposits subject to reserve requirements are defined as deposits at the *close* of the business day. No reliable estimates are available of the extent to which the money supply is thus understated. Estimates of Transactions in Immediately Available Funds vary from between $24.6 billion to $36.5 billion as of June 1976.[9] However, not all of these Transaction in Immediately Available Funds represent an understatement of the money supply since some are not just overnight funds, and some are invested before the close of the business day. Hence, the Federal Reserve should be given the right to obtain, either directly or indirectly, reports on the total volume of Transactions in Immediately Available Funds, their maturity distribution and on what time during the day they were undertaken. Since most banks do not have such transactions this reporting requirement would affect only a relatively small number of banks.

FEDERAL RESERVE PAYMENTS TO THE TREASURY

The Federal Reserve has proposed turning over to the Treasury for the next three years a sum out of its surplus that would offset any net reduction due to its payment of interest on reserves. But this proposal is merely a bookkeeping adjustment that purports to benefit the Treasury. In effect, it is devoid of any significance. This is so, because to measure the government's impact on the economy we should consolidate the Treasury's and Federal Reserve's balance sheets. This becomes apparent when one considers the reason why we impose taxes at all, instead of financing all government expenditures by deficit spending. We use taxes to reduce the public's income, and hence its demand, thus releasing resources for the government's use. Now private demand is reduced whenever the public gives up income to either the Treasury or any other government agency, such as the Federal Reserve. But if the Federal Reserve makes a payment out

[7] Professor Albert Hart, in the statement he submitted to this Committee, has suggested some other items on which the Fed should collect data.
[8] For a detailed discussion, see Gillian Garcia and Simon Pak, "Some Clues in the Case of the Missing Money," Finance Workshop Paper 67, Graduate School of Business, University of California, Berkeley.
[9] *Ibid.*, pp. 11–12.

of its capital or surplus to the Treasury nothing happens to private demand. Hence, while the government's budget document looks better because the deficit is smaller, the budget is actually just as inflationary as before since private incomes and demand are not reduced. Specifically, if the Fed pays as interest on reserves a dollar to member banks this will increase their expenditures and therefore be inflationary. And when the Fed then compensates the Treasury for the one dollar decline in its income by turning over a dollar out of its reserves nothing at all happens to offset the inflationary impact of the banks receiving an extra dollar of income and spending most of it.

To avoid giving a false appearance to the budget document the Federal Reserve should therefore be told not to turn over any of its surplus to the Treasury.

RESERVES ON TRANSACTIONS ACCOUNTS

Both the Federal Reserve bill and Chairman Reuss' amendments would impose reserve requirements on all transactions accounts. I believe that this is desirable. The purpose of the reserve requirement is to aid in controlling the quantity of money, and any deposit that can be readily transferred to a third party, is money regardless of whether it is called a demand deposit, a NOW account or whatever. Hence, there is a strong case for imposing reserve requirements in transactions accounts and nonmember bank deposits unless it can be shown that either (1) they are so small that they do not signficantly interfere with Federal Reserve control, (2) their inclusion in the reserve requirements system would make it harder to control the money stock, (3) they behave countercyclically, or (4) there should not be any reserve requirements on member bank deposits either. Let us look at each of these arguments in turn. There is considerable empirical evidence that the fact that nonmember banks do not have to meet the Fed's reserve requirements has not done any damage so far.[10] However, as nonmember bank deposits and transactions accounts in nonbanks grow relative to demand deposits in member banks this *may* no longer be the case. The imposition of a reserve requirement on nonmember banks and on institutions offering transactions accounts need not necessarily in all cases improve the Fed's control over the money stock, but it should improve the Fed's control over the money stock plus transactions balances, and this is likely to become the relevant total.[11]

It is hard to predict whether in the absence of a reserve requirement the growth of transactions accounts in nonbanks will have a procyclical or countercyclical effect. If the public shifts deposits out of banks and into these institutions as interest rates rise during an expansion, this would have a procyclical effect; while if the public shifts deposits out of these institutions into demand deposits this would have a countercyclical effect. In this case the absence of a reserve requirement on transactions balances is desirable. This case could occur only if only households are allowed to hold transactions balances, or if the interest rate paid on transactions balances were subject to a ceiling, while there would be no equally binding ceiling on demand deposit interest rates. On this general issue of the impact of reserve requirements on transactions balances on economic stability, I would like to refer the Committee to the material submitted by Professor Albert Hart. Professor Hart has also pointed out in the statement submitted to this Committee that the automatic transfer between time deposits and demand deposits which the Federal Reserve plans to permit in a few months is a step that could do a great deal of damage to the stability of the economy. H.R. 12706, by imposing demand deposit reserve requirements on these "savings deposits" would substantially reduce this danger. Hart also points out that monetary control will be greatly weakened by some recent changes in the way banks function, and he points out the need for a comprehensive examination of these changes.

The fourth possible justification for not imposing reserve requirements on transactions accounts is that there should not be any reserve requirements on demand deposits either. One can try to justify this by arguing that even without a legal reserve requirement banks would keep a certain ratio of reserves against deposits. And as long as this ratio is stable and predictable it can operate as the fulcrum for open market operations just as well as a legal reserve requirement

[10] For a review of the evidence, see George Benston, "Federal Reserve Membership: Consequences, Costs, Benefits and Alternatives," forthcoming.

[11] Cf. J. A. Cacy, "Reserve Requirements and Monetary Control," Federal Reserve Bank of Kansas City, *Monthly Review,* May 1976, pp. 3–13.

does. The crucial question is therefore whether the reserve ratio that banks and other depository institutions would keep in the absence of a legal requirement would be stable and predictable. Unfortunately, almost no information is available on this, but there is a presumption that a voluntary reserve ratio would be at least somewhat less stable than is the legally required one we have now.[12]

The upshot of all of this is that, while a system with no reserve requirements against transactions accounts and nonmember demand deposits *may* work well even if these items are a substantial component of the money stock, it would be unwise to expect that this will necessarily happen. There is a substantial risk that such a system would significantly increase fluctuations in output as well as the inflation rate.

So far I have discussed the imposition of a legal reserve requirement only from the point of view of economic stability. But there is also another aspect. If member banks have to keep a certain reserve ratio, then both equity and considerations of efficient resource allocation suggest that their close competitors, nonmember banks and institutions offering transactions accounts, should have the same reserve requirement. However, this would put transactions balances at a disadvantage relative to near-monies, such as certificates of deposits.

One possible solution is to pay interest on reserve balances, despite its costs to the Treasury. If the institutons are fully compensated for the cost of keeping required reserves then it is hard to see what the social cost of imposing a reserve requirement on their transactions balances would be.

If a reserve requirement is imposed on transactions balances how high should it be? Stabilization policy suggests that the relative reserve requirements should be proportional to the relative effects that a dollar of demand deposits and a dollar of transactions deposits have on spending; since the function of the reserve requirement is to control spending. Unfortunately, the relative effects on expenditures are hard to quantify. My own guess, but it is just a guess, is that a dollar of transactions balances raises expenditures by a bit less than a dollar of demand deposits does, so that transactions balances should have a somewhat lower reserve requirement than do demand deposits.

Finally, it is worth noting that if a reserve requirement is to be imposed on transactions balances this should be done now before these balances become very large. Once they have expanded the depository institutions may reasonably object that they undertook a large investment in setting up such accounts in the belief that they would not be subject to the implicit tax of a reserve requirement.

THE DISCOUNT RATE

One of Chairman Reuss' amendments would eliminate the Federal Reserve's authority to change the discount rate and would instead peg it to the average yield on Treasury bills auctioned on the primary market during the last two weeks. I like this proposal very much in principle, but would like to suggest modifying the details. Pegging the discount rate to an open market interest rate has been supported by many economists over the years. It has the great advantage of eliminating the subsidy that member banks obtain by borrowing at a time when, as frequently happens, the discount rate is below the Federal funds rate. It would also eliminate the "announcement effect" of discount rate changes. At present, whenever the Fed raises the discount rate to bring it into the line with rising market rates this is, despite Federal Reserve disclaimers, widely interpreted as an attempt by the Fed to raise interest rates. To avoid criticism on this score the Fed is often under pressure to let the discount rate remain for some time below the Federal funds rate. Although it can offset by open market sales, the impact on bank reserves of the resulting rise in borrowing the subsidy to borrowing banks is undesirable. Pegging the discount rate to the Federal funds rate would eliminate this problem, and is therefore desirable. The Federal Reserve's argument that discretion in setting the discount rate is sometimes useful is probably correct, but it appears that there are more times when the discretionary discount rate is a source of trouble rather than a help.

[12] However, while with no legal reserve requirement the reserve ratio actually held may be unstable it *may* still be predictable, particularly if the Federal Reserve obtains, say, weekly reports on reserves and deposits. Nonmember banks in Illinois do not face a reserve requirement. If the proposed reporting requirement for nonmember banks becomes law, this should generate data from these banks that *may* allow us to determine whether a reserve requirement is needed, or whether banks keep a stable reserve ratio on their own.

What interest rate should the discount rate be pegged to? Setting it equal to the Treasury bill rate at the last two bill auctions would create serious problems. One is that at a time when the Treasury bill rate is rising, banks could make a profit by borrowing from the Fed at the average of the last two weeks' rates, and hold bills at the higher current rate. And more generally, in recent times, the Treasury bill rate has been below the Federal funds rate at which banks lend reserves to each other. In 1977, the average yield on Treasury bills was 5.26 percent, while the average Federal funds rate was 5.54 percent, that is, 0.28 percent higher. For the first five months of 1978 the difference was 0.51 percent. Moreover, while some years ago the Treasury bill rate was a pivotal rate because banks would obtain additional reserves by selling Treasury bills this is no longer the case. Apparently, many banks no longer have a large volume of Treasury bills available for this, but are using their holdings of Treasury bills largely as collateral for governmental deposits.

Hence, the discount rate should not be tied to the Treasury bill rate. A much better pivot for the discount rate would be the Federal funds rate. However, the discount rate should not be set equal to the Federal funds rate. That would give banks an incentive to borrow from the Fed if the transaction cost of doing so is less than the transaction costs of buying Federal funds. As a result the Federal funds market may shrink. And there is no reason why the Fed should do what the private market in Federal funds already does. The discount rate should therefore be set at least somewhat above the Federal funds rate. Some years ago this would have worked a hardship on many small banks that did not have access to the Federal funds market. But this market has grown substantially, and now the great majority of all banks do have access to it, either directly, or through their correspondent banks. If the discount rate is set above the Federal funds rate only those banks that still do not have access to the Federal funds market would then borrow from the Fed in normal times, but the discount mechanism would still be available for special situations and emergencies.[13] (Admittedly, turning the discount rate into a penalty rate would reduce the attractions of Fed membership. Hence, this should be balanced either by paying some interest on reserves or by making the Fed reserve requirement lower, or else applying it also to nonmember banks.) Since the only reason for setting the discount rate higher than the Federal funds rate is to get banks to go first to the Federal funds market, the differential need not be large. One eighth of one percent should be sufficient for this purpose, and this should not be too much of a burden on any bank that does not have ready access to the Federal funds market.

One problem that arises in pegging the discount rate to the Federal funds rate, or, for that matter, to any other open market interest rate is that interest rates on different money market instruments change relative to each other. For example, if the rate on large CD's were to rise substantially it might become profitable for member banks to borrow from the Fed, and issue more large CD's. But to some extent this problem also exists with a discretionary discount rate; wherever the Fed sets the discount rate it may be out of line with some other rate. Admittedly, discretion does give the Fed the ability to select the particular market rate that it considers to be most relevant at that particular time, but, as previously discussed, in practice the constraints the Fed faces in raising the discount rate (and hence, also in lowering it temporarily) greatly limits the Fed's ability to use it flexibly in this way. In any case, a possible solution to this problem would be to set the discount rate, say 1.5 or even 2 percentage points about the Federal funds rate, and then to try to make the Federal funds market more perfect, so that all banks have ready access to it; or else, the Fed could compensate for the higher cost of discounting those banks that do not have ready access to the Federal funds market, that is the very small banks, by having a less burdensome reserve requirement for them.

FIXING THE RESERVE RATIO

Another of the Chairman's amendments would eliminate the Federal Reserve's power to vary reserve requirements. This would have little impact on the

[13] There may appear to be a problem here because in normal times if it gets known that a bank is borrowing from the Fed the market may take this as a sign that the bank is unsound, and hence it would experience an outflow of funds. But this is not really a problem because, unless it is already known that the bank is in difficulties, it would be able to buy Federal funds. Hence, knowledge that the bank is unable to do so would give the market little new information about the bank's problems.

effectiveness of monetary policy. The Federal Reserve has not used this power much and does not really need it. It originated in the Banking Act of 1935 which gave the Fed the power to double existing reserve requirements because at the time many people were afraid that the banking system, which had been accumulating large excess reserves, would suddenly begin to use them with inflationary consequences. These excess reserves disappeared a long time ago, and so did the need, if it ever really existed, for the Federal Reserve's power to change reserve requirements.

But if this power, though not needed, does not do any damage, why take it away? I believe that the answer lies in something broader than considerations of monetary policy. As a matter of principle a government agency should not be given any powers that it does not really need. More specifically, the power to change reserve requirements is the power to change the tax that this requirement imposes directly on member banks, and indirectly on depositors. This power should remain with the Congress. The Treasury does not have the power to change tax rates on its own; why should the Federal Reserve have it?

There are, however, two technical aspects of this amendment that may need further consideration. One is that reserve requirements currently apply not only to bank deposits, but also, albeit at a lower rate, to Eurodollar borrowings. It is not clear whether this amendment intends to eliminate this Eurodollar reserve requirement, or to set it equal to the reserve requirement for domestic deposits. Eliminating it entirely would give large banks a competitive advantage by allowing them to obtain Eurodollar deposits from their foreign branches without being required to keep reserves against these deposits. On the other hand, a reserve requirement on Eurodollars puts large American banks at a disadvantage in the Eurodollar market vis-a-vis their European competitors. One possible solution to this thorny issue may be to allow the Federal Reserve discretion in setting the reserve requirement against Eurodollars, but not over the reserve requirement against domestic deposits.

A second problem pertains to the graduation of the reserve requirement. This graduation would be increased by the Reuss amendment. One issue this raises is whether we should subsidize small banks at all, or let them compete on their own. After all, we do not generally subsidize small firms in other industries so substantially even though they often have to compete with much larger rivals. Admittedly, as long as nonmember banks have an easier reserve requirement than member banks do, there is a case for lower reserve requirements for small banks since they can leave the Federal Reserve System much easier than large banks can.

But leaving this issue aside, there is the form of the subsidy. Imposing a lower reserve requirement on small banks makes it somewhat harder to predict the change in the money stock that results from a given open market operation. This is so because the average reserve requirement per dollar of deposits varies somewhat from time to time, depending on the shift of deposits between large and small banks. At present, the Federal Reserve predicts changes in the money supply primarily by looking at the Federal funds rate rather than at the stock of reserves. But if the Fed should ever switch to focusing instead on the reserve base—as many monetary economists recommend—a highly graduated reserve requirement would somewhat complicate its task. Hence, if small banks are to be subsidized it would be preferable to do so by paying them a higher rate of interest on their required reserves. For example, the Federal Reserve could be directed to pay, say, 40 percent of its total interest payments on required reserves to the smallest 10 percent of member banks. Using this device small banks could be benefited just as much as they are by a graduated reserve requirement without making the money supply less predictable.

In conclusion, I would like to thank this Committee for permitting me to comment on these issues.

Mr. MITCHELL. Thank you very much, Mr. Mayer.

Mr. Crozier, we are delighted you could be with us this morning.

STATEMENT OF WILLIAM M. CROZIER, JR., CHAIRMAN AND PRESIDENT, BAYBANKS, INC., BOSTON, MASS.

Mr. CROZIER. Thank you, Mr. Chairman. It is a privilege and a pleasure to be here.

I do have prepared testimony which should be used for the record for two reasons: One, I really haven't had time to consider fully the new proposal which is before the committee and, two, from what I understand of the new proposal, I vastly prefer the older proposals and therefore find it hard to vary much from the testimony that I had prepared.

I might add that I speak only on behalf of my company, BayBanks, Inc., which is a bank holding company, one of the largest in New England, with 180 offices serving a large constituency in Massachusetts.

Six of our banks are national banks and, of course, are members of the Federal Reserve System and six of our banks are not members; five of the latter having withdrawn from membership in the Federal Reserve System in the spring of 1977.

Thirty percent of my company's banking assets therefore are within the orbit of the Federal Reserve System and 70 percent of those assets are outside the System and, of course, as you know, the Federal Reserve supervises bank holding companies and thus supervises our company.

We have done a lot of studying concerning Federal Reserve membership, some of which information has been made available to staff members of this committee. We would be more than happy to make other information available.

I am also here today, in part, to answer any questions that might occur to members of the committee. Also, I will be perfectly happy to answer questions, at some subsequent date, that the committee might have on our decisions concerning membership in the Federal Reserve System.

I can assure you we have thought about it long and carefully, took the action deliberately and, I believe, quite prudently. If there are any ways we can help the committee, you have but to ask.

I happen to like some of the formulations put before the committee: Mr. Stanton's bill in particular, as supplemented by the second of the two bills offered by the Federal Reserve System. I don't happen to subscribe to the committee chairman's amendments to Mr. Stanton's bill and I don't care for mandatory membership in the Federal Reserve System as contained in the Fed's first bill.

I would like to make an overall comment, contained in my testimony, that it is inconsistent to have institutions which are major providers of services—low cost, freely available, high quality financial services to individuals and to businesses that serve individuals—it is inconsistent to have those institutions sterilize major portions of their revenue base in idle, noninterest bearing deposits in a Federal Reserve bank.

It should be clear by now that the costs of this tax cannot be absorbed and, if incurred, will ultimately be shifted forward to the users of bank services. The corollary is if member banks face particularly intense competition from institutions that do not have to pay the tax and find it impossible therefore to shift it forward, those institutions may possibly drop Federal Reserve membership, as was the case in our institution.

As I understand the thrust of your new bill, which provides mandatory reserve requirements for all commercial banks and commercial banks only, it contains a substantial misunderstanding of the term "competitive equity." If a banking company is not capable of using the option of withdrawing from the Federal Reserve System to cope with competitive problems, you will find some other economic valve through which that pressure will escape.

Mr. Stanton's bill, therefore, I support. I also support the reduction in reserve requirements which the Federal Reserve has indicated it plans to implement as being in the right direction, and I further applaud their indication, which accompanied H.R. 13477, as to how and to what extent interest would be paid. The formulation, as I understand it, both as to the intended reduction in reserves and the proposed interest on those reserves, is drawn in such a way as to favor small and moderate size institutions—just the kinds of banks that make up our company as well as comprise many of the banking institutions in this country.

Based on our tentative calculations, I believe the above plan would be appealing enough to banks such as those in our group to warrant them rejoining the Federal Reserve System and those banks which are still members of the Federal Reserve System retaining that membership.

Furthermore, I see no harm in the ceiling that the Federal Reserve has suggested with regard to the payment of interest on reserves.

On the other hand, I do feel that mandatory reserves would be a mistake. All of us operate better with some incentive and if membership in the Federal Reserve System becomes mandated by fiat, then that incentive is lost. There should be an incentive for the Federal Reserve System to create economic formulations that will encourage and sustain membership.

After all, the Federal Reserve System has one of the country's most valuable franchises. First, it is the only true national bank in this country, but, more important than that, it is the only true lender of last resort and on any sort of reasonable cost/benefit analysis basis that fact tips the scales in favor of Federal Reserve membership. It is only when the economic gap gets incredibly large that one would consider giving up the very valuable business and economic advantage of Fed membership.

As I said earlier, I do not support the amendments to H.R. 12706. I find them an unwarranted intrusion into the Fed's management process. I also consider them a diversion from the rather clear legislation that the Fed seems to have labored long and hard to produce, as drawn around Mr. Stanton's bill.

Likewise, I strongly oppose the legislation which the committee seems to have formulated in the last day or two. Along that line, I would like to reemphasize that "competitive equity" in the community banking business—the business of serving individuals, not making loans to international governments, but serving local communities—competitive equity is an issue between all forms of financial institutions, not just commercial banks against commercial banks. You cannot legitimately discuss the issue of competitive equity unless you are willing to discuss how a matter affects all financial institutions which compete for similar categories of business.

Some of the proposals made to my right suggest that you ought to extend your new bill, if you persist in it, to all financial institutions and I would certainly agree with that. To do otherwise is to suggest that you really don't care to have commercial banks in the community banking business.

The other issue with regard to Mr. Stanton's bill that I happen to like is the idea of having the Fed's services structured by the demands of a competitive marketplace. However, I am less conversant with this topic than my associate to my left, and I am sure he has some good comments.

Thank you very much, Mr. Chairman, for allowing me to come forward and express my views.

[Mr. Crozier's prepared statement follows:]

Testimony of

William M. Crozier, Jr.
Chairman of the Board and President
BayBanks, Inc.
Boston, Massachusetts

Concerning Federal Reserve Membership,
the Payment of Interest on Reserves,
and Other Related Matters

Before the

Committee on Banking, Finance and Urban Affairs

of the

U. S. House of Representatives

August 11, 1978

My name is William M. Crozier, Jr., Chairman of the Board and President of BayBanks, Inc., Boston, Massachusetts. I appreciate the opportunity to comment on the important issues which are before this distinguished Committee.

BayBanks, Inc. was founded in 1928 and was one of the original 13 members of the Association of Bank Holding Companies formed following the passage of the Bank Holding Company Act of 1956. Today it ranks as New England's largest banking network -- 180 offices and total assets of $2.5 billion.

Twelve banks comprise the BayBanks System -- six national banks (including one currently in organization) and six state non-member banks (five of which withdrew from Federal Reserve System (Fed) membership in the Spring of 1977). Thirty percent of BayBanks' banking assets thus are within the Fed's direct orbit and 70% are without. Of course, BayBanks, Inc. itself is supervised by the Fed.

In the Summer of 1976 we conducted an exhaustive study of the Fed membership issue in the light of existing and forecasted competitive conditions in Massachusetts. In the process, we calculated the costs of keeping reserves at the Fed versus the reserve requirements of the Commonwealth of Massachusetts. We also determined the costs of alternatives to Fed services, including such items as check collection, wire transfer, securities safekeeping, and coin and currency handling. Finally, we factored into our analysis the costs of back-up lines of credit to help compensate for the loss of the Fed's discount window. We concluded that in our case -- a large, but predominately community-oriented organization -- we could no longer carry a large Fed membership burden and still meet effectively the challenges from those with lighter burdens. We concluded, as well, that our state member banks could drop their Fed membership without increasing significantly the risks in our business.

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To an operating executive with a sense, hopefully, of what is being demanded of him in the marketplace, it is encouraging to find that the trends which have developed in the last several years also seem to be requiring new prescriptions for bank regulatory involvement. The legislation before you today contains some interesting opportunities, particularly with regard to the payment of interest on reserves. To the extent that the Congress has properly responded to the needs of individuals and small businesses for low-cost, freely available, high-quality financial services, it is inconsistent to have the institutions which are major providers of these services sterilize portions of their revenue base in idle, non-interest-bearing deposits at a Federal Reserve bank. It should be clear by now that the costs of this tax cannot be absorbed, and if incurred, will ultimately be shifted forward to the users of bank services. The corollary is, of course, that if some member banks face particularly intense competition from financial institutions which do not have to pay the tax and find it impossible to shift the tax forward, those banks may very well drop Fed membership. Some member banks with a large national-international banking business may be willing to absorb the costs of membership against the scale advantages they obtain by operating in "wholesale" markets; however, those banks with predominately community banking characteristics may not be willing to do so.

Accordingly, Mr. Stanton's bill (HR 12706) to give the Federal Reserve authority (assuming such is needed) to pay interest on reserves seems to be a step in the right direction, as is the Federal Reserve's proposal to reduce reserve requirements and its further indication, accompanying the "Interest on Reserves Act of 1978" (HR 13477), as to how and to what extent interest would be paid. The formulation, as I understand it, both as to the intended reduction in reserves required and the proposed interest on those reserves, is drawn in such a way as to favor small and moderate-sized institutions. Based on some tentative calculations which we have made, I believe the plan could be appealing enough to banks such as those in our group to warrant retaining or reestablishing Fed membership. Furthermore, there seems to be little harm in the Fed's approach to a ceiling for aggregate interest payments.

The idea of mandatory reserves, however, as contained in "The Reserve Requirement Act of 1978" (HR 13476) seems to be a mistake (although I would rescue from that bill the useful amendment which lowers the ranges for member bank reserves against time and savings deposits). Even though competitive equity might be served by enacting HR 13476, it is clear that the Fed operates better with some incentive (as we all do). That incentive might be lost if reserves held either directly or indirectly at the Fed were mandated for all financial institutions. The economic formulations devised should be able to stand on their own feet as, after all, the tolerances do not have to be that tight; the Fed's lender-of-last-resort capability easily tips the balance in favor of Fed membership given any reasonably close decision on a cost-benefit basis. As far as monetary policy is concerned, I share the view that so long as the Fed has the right to require data from non-members, it can manage adequately through its control over that vast store of banking assets held in the nation's largest business and correspondent banks. The other threats to financial stability posed in the Fed's covering correspondence do not seem substantial enough to be persuasive, at least at this time.

I should emphasize, at this point, that despite their constructive approach, the new proposals referred to earlier might have a delayed impact in some of the country's intensely competitive banking markets, such as Massachusetts. Testimony abounds concerning the disruptive effects of the introduction of NOW accounts in Massachusetts, and although the worst probably is behind us, it may take a while before some banks are satisfied that the competitive situation has regained a sustainable equilibrium. In a similar vein, if such conditions were to exist in the future in other states, one still might find banks using any net earnings available from non-member status as a competitive defense. The HR 12706-HR 13477 formulation should go a long way, however, toward increasing the attractiveness of Fed membership.

Incidentally, the proposed amendments to HR 12706 do not appear to be very useful -- they seem, instead, to suggest an unwarranted intrusion into the Fed's management process. I hope that the Committee does not get bogged down by issues cast in a form which would divert it from the important purposes for which it has assembled. I might further remark how refreshing it is to find no mention of such inflammatory topics as the Regulation Q differential, nationwide NOW accounts, or the taxation of Credit Unions in the current legislation. As a result of this foresight, the odds of actually making some solid progress on the Fed membership question have been enhanced substantially.

To summarize on the membership-interest on reserves issue, I find Mr. Stanton's bill (in its original form) blended with the Fed's formulation surrounding HR 13477 (only) to be a very imaginative and creative approach to today's dilemmas.

A word also should be said about the thrust of HR 12706 in the area of explicit charges for Fed services. As large a part as possible of this bill should be retained and implemented. It is clear that the time has come to give the Fed's customers the benefits of a service line structured by the demands of a competitive marketplace. Moreover, the Fed's services should stand on their own, in an unbundled fashion, so that these services do not merely become "free goods" against an implicit credit for balances so large the credit can't be spent. The thrust of Mr. Stanton's bill is to require that Fed services be set up on a businesslike basis. No doubt there will be some uncertainties in the process; however, competition requires a bit of uncertainty. And we may never obtain the full benefits which competition might bring in the payments services area until the Fed becomes a properly constituted competitor.

Mr. MITCHELL. Thank you very much, Mr. Crozier.
Mr. Romberg?

STATEMENT OF BERNHARD W. ROMBERG, PRESIDENT, PAYMENT AND ADMINISTRATIVE COMMUNICATIONS CORP., NEW YORK, N.Y.

Mr. ROMBERG. My name is Bernhard W. Romberg and I am president of an organization generally known as the BankWire.

I appreciate this opportunity to present our views on the need for equitable pricing of operational services provided by the Federal Reserve in the payments systems.

My comments will be presented from the standpoint of a private sector business which feels that the Fed is competing with the private sector in providing payments services and, as such, these comments may be presented from a perspective different from those of witnesses who have appeared previously either today or another day.

The BankWire is a business cooperative providing low cost and efficient funds transfer services. We operate a substantial computer-based switching system which, on an average day, handles 18,000 communications involving over $20 billion in interbank payments.

Our operations are financed completely through charges to our users, which are based on a standard fee of 60 cents per message.

As a business cooperative, the BankWire is owned and managed by its member banks. Our 185 member banks are located in 36 States. Of these, over 90 percent belong to the Federal Reserve. Membership in the BankWire is open to any financial institution providing depository banking services.

I want to emphasize the BankWire is an industry-owned, industry-financed and industry-managed payments systems activity. We have been providing wire transfer services since 1952.

In May of this year, BankWire II, a major new computer communications system, went operational and replaced our previous system.

This new system represents a significant commitment, over $10 million, by the private sector to provide for banking's current and future needs in interbank payments.

The Federal Reserve also operates a funds transfer system, generally known as the FedWire. A rapidly growing use of this system is for third party wire transfers between commercial banks. Preliminary results of Bank Wire surveys show that such third party transfers represent a predominant use, between 60 and 80 percent, of the FedWire by commercial banks.

We do not question that the Federal Reserve may need a wire system for its own operation, but with its third party funds transfer services, the Federal Reserve is providing services which are comparable to those which have been provided for some time through the BankWire.

Mr. MITCHELL. Mr. Romberg, may I interrupt you for a just a moment to remind the members we will continue our platoon system. When we have a vote, one platoon will vote and the other platoon will continue the hearing. We do have the permission to continue sitting during the 5-minute rule.

Thank you for allowing me to interrupt you.

Mr. ROMBERG. Furthermore, the Federal Reserve is actively pursuing a program to expand the use of the FedWire for third party transfers. As for charges, the FedWire is basically free to the banks that use it. With the BankWire, we must recover all of our costs through a charge of 60 cents.

As shown in the figures in my testimony, these costs include all communications lines, computer hardware, development, salaries, general and administrative overhead, working capital, as well as Federal, State, and local taxes. With the FedWire users are not charged for any of these normal business expenses. The activities of the Federal Reserve in wire transfer services have had a profound impact on our organization. Since 1974, membership has declined from 230 to 185 today. We also have a membership problem.

Of even greater impact has been the decline in average daily message traffic from 26,000 per day to the current level of 18,000.

At the same time, the Federal Reserve has reported the usage of the FedWire as approximately 70,000 transactions per day and growing at a rate of 15 to 20 percent per annum.

Surveys of our members, as well as in-depth interviews with members who have left the System, clearly indicate the two most important reasons for the declining use of our services.

The first of these is cost. The second of these, which I will touch on briefly, is settlement.

The FedWire is free, while the BankWire costs 60 cents per message.

With the continued pressure on operating costs, there is a natural inclination on the part of the operating personnel and banks to take whatever steps they can to reduce costs and this in turn leads to significant diversion of traffic from the BankWire.

If the FedWire were to charge properly allocated costs, we believe the BankWire would be more than competitive under such circumstances, and if the BankWire were able to provide settlement, we are confident that we would carry a major fraction of the third-party transfer.

In the interests of time, I will skip portions of my testimony dealing with a somewhat technical aspect of access to the Fed which I referenced before, known as settlement.

The situation is described in our submitted testimony. However, I do wish to emphasize the importance of incorporating in legislation the need for the Fed, in providing services and access to its facilities, to do so in a way that permits the private sector to have full and competitive access and which does not permit the Federal Reserve to use its role as a central bank to limit such access and thereby keep private sector payment services in a second-class status.

With respect to the proposed legislation, my comments will be based primarily on proposals considered before, but I believe they are also applicable to the present legislative considerations. It is our fundamental conviction that any legislation affecting the operations of the Federal Reserve should require the Federal Reserve to charge explicit prices for payment-related services.

In particular, such charges should apply to the wire transfer of funds, check collection, automated clearinghouse services, net settlement services, and other services as called for in Mr. Stanton's original bill.

To assure a legitimate competitive environment where the private sector would find it economically feasible to provide services and create initiatives, it is essential that the Federal Reserve, in its pricing for services, take into full account all direct and indirect costs incurred in providing such services, including overhead, an allocation of computed costs that would take into account taxes that would have been paid and the return on capital that would have been provided had the payments services been furnished by an organization in the private sector.

In its pricing, the Federal Reserve certainly should be given every opportunity to be as competitive as possible. However, it should not be permitted to use its resources or unique position as a central bank to provide services at artificially low costs, even if this is done only with the declared intention of being competitive. If the private sector is able to introduce services of a particular class at low cost or is prepared to risk its capital with a hope of a long-term profit, this does not mean that the Federal Reserve should be allowed to charge less than fully allocated cost, in effect, using price cutting and its predominant position to suppress competitive initiative.

Finally, there should be no tie-in between the charging for services and reserves. For instance, any restriction which would limit interest on reserve balances to the purchase of services or some absolute percentage relationship tied in any way to the purchase of services would, in the private sector, probably be construed as an illegal tie-in sale.

For these to be a truly competitive environment, it is essential that the Federal Reserve, as a provider of payments services, be separated completely from its other activities as a regulator of the banking industry, manager of the Nation's money supply and fiscal agent of the Federal Government. Thus the charging and operating practices of the Federal Reserve should be such that the private sector can also compete in providing payments services to the Treasury and other departments of the Federal Government.

With respect to the legislation under most active consideration, we strongly recommend that there be explicit wording calling for pricing of Federal Reserve payments services along the lines called for in Mr. Stanton's original bill.

We are absolutely convinced that requiring the Federal Reserve to charge fully allocated costs for its payments services will bring about major innovations and expansion in such services which will be of far-reaching benefit to the public—both individual consumers and corporations.

There have been tremendous strides in computer, communications, and other technologies which are applicable to new and efficient payments services. It is, however, essential that the artificial depressant of the free payments services provided by the Federal Reserve be eliminated. Once users have to pay the requisite costs for services there will be a realistic economic environment in which others can compete with the expectation of a reasonable return.

Different services will be introduced as a result of competitive innovation to meet the differing needs of the marketplace. New businesses will be formed and private sector employment will grow. Our economy is too complex, too dynamic, to be served adequately by a single approach to payments.

In summary, we believe that by calling for the Federal Reserve to charge fully allocated explicit prices for its payments services, the Congress will be enacting legislation which will be of long-term and far-reaching benefit to the entire economy.

It will lead to new economic activity in the private sector which will also increase employment, as well as having the salutary effect of increasing Treasury revenues from additional taxes paid by the private sector.

Gentlemen, I appreciate your attention.

[Mr. Romberg's prepared statement follows:]

STATEMENT BY

BERNHARD W. ROMBERG

PRESIDENT, PAYMENT AND TELECOMMUNICATION SERVICES CORP.

BEFORE THE

COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS

HOUSE OF REPRESENTATIVES

AUGUST 11, 1978

THE BANKWIRE

A Private Sector Provider of Payments Services

Testimony presented before the

Committee on Banking, Finance and Urban Affairs
U.S. House of Representatives

August 11, 1978

INTRODUCTORY COMMENTS

My name is Bernhard Romberg and I am President of the Payment and Administrative Communications Corporation and its operating subsidiary, the Payment and Telecommunication Services Corporation. These corporations, also known as the BankWire, provide wire transfer funds payment services to the banking industry. I appreciate this opportunity to present the BankWires views to the House Banking Committee on the need for equitable pricing of operational services provided by the Federal Reserve in the payment systems area.

First, I will describe the organization and activities of the BankWire as a private sector provider of electronic funds transfer services. I will then discuss the effect of Federal Reserve activities in this area, commenting particularly on pricing and access. My

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comments here will focus on that segment of the payments mechanism related to wire transfers. I will then discuss our views on the legislative proposals being considered by this Committee, limiting my comments on those aspects related to the charging of services provided by the Federal Reserve.

THE BANKWIRE

The BankWire is a private corporation organized as a business cooperative to provide banks with low cost and efficient funds tranfer services for interbank payments. It operates a substantial computer-based switching system which, on an average day, handles 18,000 communications involving over 20 billion dollars in payments, thus playing an important role in the nation's payments mechanism. The BankWire's operations are financed completely through charges to its users, which are based on a standard fee of 60¢ per message.

The BankWire is a private sector business cooperative providing wire transfer services to banks.

As a business cooperative, the BankWire is owned and managed by its member banks. All banks using BankWire services are members of the cooperative and have a voice in the management of the organization. Its 185 member banks are located in 36 states. Over 90% belong to the Federal Reserve and there are members in every Federal Reserve District. The deposit assets of this membership are in excess of 500 billion dollars, or more than 60 percent of the nation's commercial bank deposits. Membership is open to any financial institution providing depository banking services.

BankWire membership is open to any financial institution providing depository banking services.

The members elect annually a Board of Directors, who are also senior officers of member banks, in such a way that there is at least one director from each Federal Reserve District, thereby assuring nationwide representation. The BankWire's form of organization has been approved by both the Federal Reserve Board and the Comptroller of the Currency, and its cooperative status has been approved by the Internal Revenue Service. We wish to emphasize that the BankWire is industry owned, industry financed, and industry managed, with membership open to all financial depository institutions.

The BankWire is industry owned, financed & managed.

The BankWire of today and its predecessor organizations have been providing wire transfer services since 1952. BankWire I, an automated system, served the banking industry well from 1968 until May of this year. In May, BankWire II, a major new computer-communications system went operational and replaced the previous system. The specifications for BankWire II were developed by representatives from banks--large and small--from all over the country. The system features new types of transactions and facilities for better management of funds transfer activities. It will also have a significant capability for batch transmission, which can be used for inter-ACH (Automated Clearing House) requirements as well as direct batch communications between members. High reliability and efficiency have been achieved through the use of the latest in computer and communications technology. BankWire II represents a major commitment--over 10 million dollars--by the private sector to provide for banking's current and future needs in interbank payments.

The BankWire has been in operation since 1952. A new system went operational in May, 1978.

PRICING AND FEDERAL RESERVE WIRE TRANSFER SERVICES

The Federal Reserve operates a substantial funds transfer system, generally known as the Fedwire. A major--and rapidly growing--use of this system is for third party wire transfers between commercial banks. Typically, these are transfers--or payments--made from one bank to another where the payment is to be credited to the account of a customer of the receiving bank, the so called "third party". Preliminary results of BankWire surveys show that such third party transfers represent the predominant use--between 60 percent and 80 percent--of the Fedwire by commercial banks. These are transactions made by banks on behalf of their customers and need not involve the Federal Reserve directly. The Federal Reserve is thus providing services which are comparable to those which have been provided for some time through the BankWire. Furthermore, the Federal Reserve is actively pursuing a program to expand the use of the Fedwire for third party transfers--thereby enlarging its role in an area already served by the private sector.

The Fedwire, operated by the Federal Reserve, provides third party wire transfers in competition with the private sector. For many banks, third party funds transfers constitute the predominant use of the Fedwire.

As for charges, the Fedwire is basically free to the banks that use it. There is a charge for the terminal equipment located on a bank's premises, and a nominal charge for those few third party transfers which are for amounts less than $1,000, but for all practical purposes there is no charge for the overwhelming bulk of usage.

This situation can be compared with the BankWire, which must recover all of its costs through a charge of 60¢ per message. As shown in Figure 1, these costs include all communications lines, the computer hardware, systems development, all salaries, general administration and overhead, working capital, as well as Federal, state, and local taxes. With the Fedwire, users are not charged for any of these normal business expenses.

There is no charge for most Fedwire transfers, whereas the BankWire charges 60¢ per transfer.

IMPACT OF THE FEDWIRE

The activities of the Federal Reserve in wire transfer services have had a profound impact on the BankWire. Since 1974, membership in the BankWire has declined from 230 to 185 today, or a decrease of 20 percent. Of even greater impact has been the decline in average daily message traffic from 26,000 per day to the current levels of 18,000, equivalent to a 31 percent drop. At the same time, in talks given at various conferences, the Federal Reserve has reported that usage of the Fedwire is approximately 70,000 per day, and growing at a rate of 15 to 20 percent per year.

BankWire membership and usage has declined in recent years.

Surveys of present BankWire users, as well as in-depth interviews with members who have left the system, clearly indicate the two most

FIGURE 1

COMPARISON OF BANKWIRE AND FEDWIRE CHARGES

	COMPONENT	BANKWIRE	FEDWIRE
1.	TERMINALS	AT COST FROM VENDOR	GENERALLY AT COST FROM VENDOR
2.	COMMUNICATIONS LINES		
3.	COMPUTER HARDWARE		
4.	OPERATIONS a. PERSONNEL b. SITE	INCLUDED IN STANDARD	NO CHARGE TO
5.	DEVELOPMENT/REPLACEMENT	CHARGE OF 60¢	USERS
6.	MARKETING/USER LIAISON	PER MESSAGE	
7.	ADMINISTRATION		
8.	WORKING CAPITAL		
9.	TAXES a. Federal b. State c. Local		

important reasons for the declining use of the BankWire. The first of these is costs; the second of these--which I will discuss shortly--is settlement. The Fedwire is free, while the BankWire costs 60¢ per message. With the continued pressure on operating costs, there is a natural and understandable inclination on the part of operating personnel to take whatever steps they can to reduce costs, and this in turn leads to the significant diversion of traffic from the BankWire to the Fedwire. Declines in traffic have been a major factor in forcing the BankWire to increase its unit message charge, which in turn leads to further traffic declines.

One of the major reasons for these declines has been the availability of the Fedwire for no cost transfers.

If the Fedwire were to charge properly allocated costs, including development expenses, equipment, and factors for the cost of capital, we have good reason to expect BankWire charges would be more than competitive with the Fedwire. Under such circumstances, and if the BankWire was able to provide settlement, we are confident that the BankWire would carry a major fraction of the third party wire transfers, which would assure its long term viability.

If the Fed had to charge properly allocated costs, we are confident that the BankWire would carry a major fraction of third party transfers.

ACCESS FOR SAME DAY NET SETTLEMENT

The second significant factor in the decreasing use of the BankWire is a difference in the settlement mechanism for funds transferred through the Fedwire as compared to those through the BankWire. Because of its unique role as a central bank, the Federal Reserve can settle transfers from one bank to another by debiting the reserve account of the sending bank and crediting the reserve account of the receiving bank. This provides "immediate availability" of the funds transferred. To be competitive from a product/service standpoint, the BankWire needs access to this settlement mechanism.

The other major factor leading to a decline in BankWire usage has been a difference in settlement mechanisms.

The BankWire membership has designed a highly efficient means of accomplishing settlement, known as "net settlement". With net settlement, the BankWire would accumulate totals for the funds transfers sent and received by each bank and then report this to the Federal Reserve as a single net debit or credit balance for each bank. These balances would be posted by the Federal Reserve to the member bank's reserve account on that same day. With this facility, the transfers through the BankWire would provide "same day availability" with many fewer settlement entries flowing through the

The BankWire needs a facility for same day net settlement through reserve accounts to be able to compete on a product basis.

central bank system. This would also simplify and facilitate present reconciliation procedures as well as reducing peak volume bottlenecks in the Fedwire. Implementation of this service requires that the BankWire have access to the Fed's settlement system in such a way as to permit the BankWire to be competitive with the Fedwire. Without this same day net settlement capability, the future viability of the BankWire as a private sector alternative is in doubt.

It should be noted that this net settlement approach continues the role of the Federal Reserve System in the final settlement process of the payments mechanism without requiring each individual payment transactions to be processed over a system operated and subsidized by the Federal Reserve. This approach is in accord with the recommendations of the National Commission on Electronic Funds Transfers in that it enhances the development of the private sector clearing arrangements without expanding the role of the Federal government in the payments mechanism.

The Bank net settlement approach is in accord with recommendations of the National Commission on EFT.

In December, 1977, the Federal Reserve announced its intention to provide the BankWire access for net settlement. Since March, we have been working with Federal Reserve System personnel to define more precisely the operational, technical, and legal aspects related to such settlement. It should be emphasized that, for the BankWire to be able to provide wire transfer and related payments services which are realistically competitive with those which are provided by the Federal Reserve, it is essential that there be a reasonable degree of functional parity between BankWire funds transfer services and those available through the Fedwire. This can be accomplished by having the Federal Reserve apply the same acceptance criteria to a BankWire net settlement statement as to any other Fedwire transaction and promptly acknowledge the finality of such balances or notify the BankWire that some balance is not acceptable. Anything less than this would prevent the BankWire from providing competitive capabilities.

It is essential that it be possible for the BankWire to provide settlement which provides for functional parity with the funds transfer services of the Federal Reserve.

With the introduction of realistic charges for all services and by giving other providers of payment services equitable access to facilities which are currently unique to the Federal Reserve (because of its central bank role), the BankWire and other organizations will be able to compete in providing efficient and innovative payment services to meet the nationwide range of consumer and corporate needs.

COMMENTS ON PROPOSED LEGISLATION

It is our fundamental conviction that any legislation affecting the operations of the Federal Reserve should require the Federal Reserve to charge explicit prices for payments related services. In particular, such charges should apply to the wire transfer of funds, check collection, Automated Clearing House services, net settlement services, and any services related to the electronic transfer of funds.

The Federal Reserve should charge explicit prices for all payments services.

To assure a legitimate competitive environment, where the private sector would find it economically feasible to provide services and create initiatives, it is essential that the Federal Reserve, in its pricing for services, take into full account all direct and indirect costs incurred in providing such services, including overhead, an allocation of imputed costs that would take into account taxes that would have been paid, and the return on capital that would have been provided had the payment services been furnished by an organization in the private sector--as well as all directly identifiable costs for operations, development, marketing and user support services. To do otherwise would encourage the less efficient check payments system rather than an electronic one.

Federal Reserve pricing should take into account all direct and indirect costs.

In its pricing, the Federal Reserve certainly should be given every opportunity to be as competitive as possible. However, it should not be permitted to use its resources or unique position as a central bank to provide services at artificially low costs, even if this is done only with the declared intention of being competitive. If the private sector is able to introduce services of a particular class at low costs or is prepared to risk its capital with the hope of a long term profit, this does not mean that the Federal Reserve or any governmental agency should be allowed to charge less than its fully allocated costs (including various imputed allowances), in effect using price cutting and its predominant position, to suppress competitive initiatives.

The Federal Reserve should be allowed to compete as though it were a private sector organization.

Finally, there should be no tie-in between the charging of services and payment of interest on reserves. For instance, any restriction applicable to a particular bank which would limit the interest it receives on reserve balances to the cost of services it purchases, or some absolute or percentage relationship tied in any way to the purchase of services would, in the private sector, be construed as an illegal "tie-in sale". For there to be a truly competitive environment, which would permit private sector initiatives, it is essential that the activities of the Federal Reserve as a provider of payments services be separated completely from its other activities as a regulator of the banking industry, manager

There should be no tie-in between Federal Reserve pricing and reserve balances.

of the nation's money supply, and fiscal agent of the Federal government. Thus, the charging and operating practices of the Federal Reserve should be such that the private sector can also compete in providing payments services to the Treasury and other departments of the Federal government.

With respect to the charging for payments services provided by the Federal Reserve, we believe that the bill introduced by Congressman Stanton (H.R.12706) represents sound and constructive legislation, and encourage its favorable consideration. We do suggest that it could be improved by further wording which would restrict the Federal Reserve from engaging in any pricing or other competitive practices which would be prohibited in the private sector. We would also encourage more rapid implementation of the pricing of such services, calling for these to be announced by July 1, 1979 and implemented by January 1, 1980, instead of July 1, 1980 as suggested in H.R. 12706.

The BankWire concurs with the pricing proposals called for in H.R. 12706...

...but recommends faster implementation.

We are absolutely convinced that requiring the Federal Reserve to charge fully allocated costs for its payment services will bring about major innovations and expansions in such services which will be of far reaching benefit to the public--both individual consumers and corporations. There have been tremendous strides in computer, communications, and other technologies which are directly

Federal Reserve pricing of services will bring about major innovations and expansions in services.

applicable to new and efficient payments services which can meet a large variety of individual needs. It is, however, essential that the artificial depressant of free payment services provided by the Federal Reserve be eliminated. Once users have to pay the requisite cost for services, then there will be a realistic economic environment in which others can compete with the expectation of a reasonable return. Different services will be introduced as a result of competitive innovation to meet the differing needs of the marketplace. New businesses will be formed and private sector employment will grow. Our economy is too complex--too dynamic--to be served adequately by a single approach to payments--just as one type of automobile does not meet the needs of all consumers, nor does one style of clothing meet everyone's desires.

Alternate approaches and suppliers are needed.

The Federal Reserve proposal H.R. 13477 is not adequate in that it does not provide for the pricing of Federal Reserve services. In the Federal Reserve's July 10 press release, the Board also suggests that it might not price any services if its program for universal reserve requirements were enacted. This would continue a government subsidy of the payments mechanism while stifling private sector initiatives.

H.R. 13477 allows the possibility of continued government subsidy of the payments mechanism.

In summary, we truly believe that, by calling for the Federal Reserve to charge fully allocated explicit prices for its payments services, the Congress will be enacting legislation which will be of long term and far reaching benefit to the entire economy. This will come about because such competitive pricing will provide an environment in which the private sector can compete in providing higher quality and lower cost services to the public and the government. It will lead to new economic activity in the private sector, which will also increase employment as well as having the salutary effect of increasing Treasury revenues from additional taxes paid by the private sector. To prevent such charges from being punitive, the Federal Reserve should alleviate the present burden of re-reserves imposed on its membership. However, any such relief should be completely separate from, and in no way conditioned upon, the purchase of Federal Reserve payments services.

Charging for Federal Reserve services will be of major long term benefit to the public and the economy.

Mr. MITCHELL. Thank you very much and thank all of you gentlemen for your testimony this morning. We do have a vote on. I would assume this is the first vote on some momentous issue like approving the journal from yesterday or deciding to go into the committee of the whole House and I will forego participating in those momentous decisions.

Mr. McCracken and one other witness raised some concern about whether the Fed should have the right to alter the reserve requirements in a real emergency. As I recall from previous testimony in my subcommittee—Domestic Monetary Policy—this issue came up and both Governor Pardee of the Federal Reserve and the Honorable Roger Altman from Treasury agreed that a 5 or 6 percent reserve should meet most of the national financial emergencies that should occur. They went on further to say that in the event of some emergency of horrendous dimensions there might be some change required.

Based on that testimony, I think I will recommend to the full committee that we merely put in the report language attempting to define what constitutes a true national emergency of enormous dimensions, if it can be done, and, under these conditions to then give the Fed the power to alter the reserve requirement. Would that be a satisfactory solution for you?

Mr. McCRACKEN. Precisely. That is the sort of thing which occurred to me. The leeway in reserve requirements for Federal Reserve needs is not for the normal execution of monetary policy, which seems to be the half percent implication. Neither does that bother me much.

What the System does need is the authority to act quickly to go outside the boundaries here.

For example, as I was framing my comments here—of course, this is not in my statement—something like giving them the authority to suspend these reserve requirements during an interlude before it might be possible for the Congress to act, or something like that might make sense—to take cognizance of the kind of emergency Mr. Schechter was talking about. Or, as I say, historically we need to remember there has been this kind of problem on the other side where we had a flood of reserves suddenly coming in and had to absorb them.

Mr. MITCHELL. In testimony today, each of you gentlemen referred to the new innovations in our economic system, and that these new innovations tend to blur the lines between the traditional demand deposits and savings deposits. Today we have such things as NOW accounts, telephone transfer accounts, preauthorized overdraft accounts, and so forth. It is thus quite true that the lines are becoming blurred between the traditional approaches and these new innovations. In light of this, I would like to hear from each of the panel members on whether it would be efficient and perhaps wise for the purpose of monetary control to set a uniform reserve requirement for all types of deposit liabilities, straight across the board. I think, Mr. Crozier, you alluded to that.

If I have made my question clear, would you care to comment? We will start with Mr. Schechter.

Mr. SCHECHTER. I would not like to see the reserve requirements applicable to all types of accounts in all the national institutions. I believe that where the funds can be used for loans immediately on a short-term basis rather than for the—well, I am concerned about any inhibition on funds that go to housing at this time, and for those institutions which have a requirement to have a high proportion of their assets in housing mortgages, I think they draw upon long-term savings only for that purpose.

To the extent that they have transaction accounts or NOW accounts, yes, I would say there should be reserve requirements.

I might note from figures I have looked at—and they are not exactly up to date, but the total of all the NOW accounts at all types of institutions—NOW accounts and other transaction accounts, it is less than 1 percent of all deposit balances, so it is still a very small item.

Mr. MITCHELL. But we would expect them to grow in the future, would we not?

Mr. SCHECHTER. It could grow some although I gather the savings and loans, for example, are not as enthusiastic about NOW accounts as they were previously.

As to the question of commercial bank time and savings deposits, I think it is different than a savings and loan in that they have complete freedom to put those funds into short-term loans of various sorts and meet short-term credit needs so I think there is a distinction there.

Mr. MITCHELL. Do the other gentlemen care to comment on this? Mr. Jordan.

Mr. JORDAN. I would comment in that I believe all transaction-type balances at all institutions should be treated alike or viewed alike for monetary policy purposes.

If the objective is either liquidity, or monetary control to influence economic activity, then we ought to view these types of accounts or balances as being the same, whether the institution is a savings and loan association, a credit union, or a commercial bank. I don't see the usefulness of having an idle cash reserve requirement in any institution, bank or nonbank, 6- or 8-year savings certificates, so I would not subject them to a reserve requirement.

The current bill does require commercial banks to have a reserve requirement on time and savings deposits, and I will not repeat my earlier suggestion as to the form of those. I do not see the point of subjecting nonbanks' savings liabilities to a reserve requirement, any more than banks. However, you have some large thrift institutions, mainly mutual savings banks—$4- and $5-billion institutions—that are in effect offering checking accounts in the northeast part of the country. I think that on these kinds of accounts, information should be collected for inclusion in the money supply.

The outstanding amount is not so large now compared to the total of demand deposits outstanding, but the growth rate is high and the growth rate influences the money supply growth rate. Soon we will have automatic transfer accounts, with large thrift institutions that are able to make automatic transfers out of a savings account that is tied to a checking account—to them a NOW account. They will be very involved in the payments system in the form in which people hold their money, and I would make them subject to the same kind of reserve requirements as commercial banks. Specifically, exempt the first $100 million of deposits, but then treat the transactions liabilities of less than 90 days at larger thrift institutions the same as at banks.

Mr. MITCHELL. Any further comment?

Mr. MCCRACKEN. In my original testimony which—of course, was directed to the original collection of bills—I had taken the position that I thought all transactions balances, regardless of where they were, ought to be subject to reserve requirements.

I find the approach here of trying to simplify the structure of reserve requirements by having a uniform requirement does have a good deal of merit.

I believe I would support the view therefore, that these nonbank thrift institutions ought to be included within the rubric of reserve requirements.

However, this is a very complex question and I am not quite sure that it has matured to the point where we are quite ready to move. At least that would be my view.

Mr. MAYER. I think the main thing we have to do is include the accounts of the nonbank institutions. As for savings accounts, I think the shorter term ones should also be covered, though it is not necessary on 8- or 6-year certificates of deposit.

Mr. CROZIER. I certainly think you ought to include not only transaction accounts, but savings accounts. As you well know, the Federal Reserve has come up with a new formulation, effective November 1, whereby you can run a zero balance checking account and have funds transferred from your savings account to cover overdrafts. By definition, they have confirmed the notion that any savings account—any account in the bank where you can go to the window and get money that day—you don't have to wait 90 days or until a certificate matures or pay a penalty to get it or do something of that sort—is a demand account and ought to be subjected to the same rules across the breadth of all institutions.

Incidentally, since somebody has introduced some information concerning the size of NOW accounts, I would be happy to add data from the balance sheet of our institution as of June 30, 1978, which shows among other things, NOW accounts of $250 million out of total deposits of $2,100 million. That is certainly more than 1 percent of our deposit liabilities and a significant item. NOW accounts in the Commonwealth of Massachusetts are well in excess of $2 billion and represent far in excess of 1 percent of the deposits in that State.

Mr. ROMBERG. I have no comment.

Mr. MITCHELL. I am sure my time has expired. Chairman Reuss.

The CHAIRMAN. Thank you very much. I want to express my gratitude to the panel not only for their excellent testimony, but for adjusting themselves, with very little notice, to the revised bill which has been taking form just within the last few days.

I think your comments on it are invaluable.

Mr. Mayer, you said you regretted the removal from the draft statute of the provision linking the discount rate to the Treasury bill rate.

Mr. MAYER. Yes.

The CHAIRMAN. Let me tell you about that. We have just, in the last day or two in the course of taking that out of the statute, written the Federal Reserve strongly urging that they, for practical purposes and as much as possible, link their discount rate either to the Treasury bill rate, the Federal funds rate, the prime rate, or whatever series seems to them to make the most sense. Treasury bills, with Arabs buying them in large numbers, seems to us, a little risky thing to mandate; so our feeling is, let us see whether the Fed can't work this out by themselves and stop giving false signals inadvertently.

I think, if they do it, it will please you and accomplish what is in your mind.

Let me also say to Mr. McCracken that I am very grateful to you for your admonition to us. In the event we enact legislation, something like the new package before us, we must remain alert in the years to come to the changing world. I can assure you that we will do that.

Right now it is pretty hard to tell what is going to happen to NOW accounts nationally, what is going to happen to regulation Q, what will be the effect on November 1 of the Federal Reserve marriage between time and demand deposits, therefore, our feeling is that we can blow the whistle on further attrition. If we find inequities are creeping in, we can act in plenty of time. I would reinforce what I just said to you, as my strong personal view, by saying, if we are forced to do that, as far as this member is concerned, grandfathering isn't going to mean a thing.

This race will not be to the swift or the fellow with the best lawyers, it will be in the interests of monetary control.

Mr. Schechter made many interesting points. One, I would like to comment on now.

Mr. McCracken backed you up on this. You said if you have a fairly static reserve requirement in this proposed bill—6 percent, whatever, it is—and there were needs for rate flexibility, you might find that big banks, the member banks, were happily taken care of at the discount window but smaller banks would be left out in the cold and maybe their correspondents couldn't take care of them.

I think you have a good point there. I would think that point could, in large part, be met if we added to the draft bill before us a requirement that where either the FDIC or the State regulatory agency is willing to certify to the Fed that a nonmember bank is standing in the need of discount window treatment, that it get it on about the same terms as it would if it were a member bank, perhaps with a penalty interest rate, but that the money be made available. Wouldn't that, to a large extent, meet your flexibility point?

Mr. SCHECHTER. I think it would go in that direction. Mr. Jordan also suggested something along those lines. I am thinking of something where you might require almost an overnight action, when suddenly a panic develops, which has happened upon occasion in our history.

There should be the authority for someone to say, if it is a 6-percent level, we can go down to 3 percent overnight, increasing liquidity from reserves that are available. That is for the whole system.

The CHAIRMAN. Couldn't that be done by open market policy?

Mr. SCHECHTER. I would prefer someone answer that who is more knowledgeable on liquidity, but I would have more faith in the stroke of the pen being able to achieve that overnight.

Mr. MCCRACKEN. I would support Mr. Schechter on this. The basic point that changes in reserve requirements are not a good way of executing monetary policy I think is very well taken. For that reason I don't attach much significance to that half a percentage point either way. It seems to me the one contingency where there might need to be Federal Reserve authority in regard to reserve requirements would be if there was some panic such as historically we have had or some international incident, which would produce a panic massive inflow of funds to enormously increase our reserve, such as occurred here in the thirties.

The CHAIRMAN. You would phrase that in terms of extraordinary emergency?

Mr. McCRACKEN. Exactly.

The CHAIRMAN. Otherwise it would defeat the whole purpose.

Mr. McCRACKEN. I couldn't agree more.

As I say, I am not trying to write the bill, but there might be some such language as:

> In the event of an emergency, the Board, with an affirmative vote of five members and a report to the Congress on the reasons for its action, would have the authority for x days to double the reserve requirements or reduce them by 50 percent.

In other words, I am not very much concerned about the half a percent but I am concerned about giving them the power to deal with this remote contingency.

The CHAIRMAN. I think it is a suggestion which deserves very serious consideration.

Mr. MITCHELL. Mr. Stanton is recognized.

Mr. STANTON. Thank you very much, Mr. Chairman.

Gentlemen, I wish to add my thanks to those of the Chairman for your appearance here this morning. I realize some of you have come quite a long ways at quite a bit of sacrifice from your own businesses. We do appreciate it.

At the outset I would like to lay to rest the idea that perhaps your appearances on the testimony of which you had spent considerable time to prepare seem to be obsolete at the moment and I, for one, want to make sure that you don't leave here with that thought in mind. In reality, I, for one member of the committee, am most hopeful that while we will put aside temporarily the subject matter of pricing of services and the paying of interest on reserve requirements, it is still going to be with us and your testimony in that regard will be very valuable.

I know this member and I hope more of the members will find it educational.

What we are faced with in reality—and the chairman I think will verify this—we are here this morning as a result of initiations by the Federal Reserve Board to tackle their specific problem and the problem in general that we have come to recognize, which is a loss of membership in the Federal Reserve System. This subject has been with some of us on the committee for several years.

We have promised the Chairman of the Federal Reserve Board that we would do our utmost in the very limited time period that we have to help them in this regard. We have a hard time convincing him I think of the political facts of life, with which you are quite familiar, Mr. McCracken. We have no chance next week except on Monday for further discussion; we will be gone for 3 weeks.

We hear the Rules Committee is closed for further business. We are back for 1 month. We read in the papers every day about the pressures between the President and the Speaker and time schedules. We have bills before the Rules Committee we reported out months ago. We can't get action on the House floor. It comes down to the practical reality where next week we will have to decide to limit it to something we could pass on the consent calendar, where we have to get two-thirds of the membership for passage.

I give the chairman credit because he is getting like Wilbur Mills; he has three bills and he throws out amendments and he throws out new bills and when he gets a consensus, then he goes forward. He is very fair and we enjoy working together.

In conclusion, before I ask a question, let me just thank you once again and reiterate to you that your testimony—I read most of it last night—is a valuable contribution to the overall subject.

As we consider narrowing the scope of this bill, we concentrate on the Fed lowering reserve requirements and we start into the subject of moving from a flexible rate to a statutory rate with a small percentage of leeway.

I would be curious if you gentlemen share at all the thoughts that entered my mind, of what reaction would the international financial world have to our actions?

We now have gold going to $210 and a decrease in the dollar. Would this be at all interpreted as weakening of the authority of our central bank here, or am I off base in giving any thought to this?

If you have any thoughts on that, I would be interested to know.

Mr. JORDAN. It is possible, depending on how it was handled and the timing. If it was just the Fed reducing reserve requirements, that could be construed as having a monetary policy interpretation that would be disturbing on foreign exchange markets.

This wouldn't take effect any time soon, and it probably would be a period at least 6 months from now when there is a lower level of economic activity and an easing action might be construed as appropriate. However, even then it should be stated that this is not done for monetary policy purposes; that the central bank, through its powers in the open market, would make sure that the growth in money supply and the growth of bank reserves and monetary base was not influenced by this action.

The Federal Reserve currently, on a daily basis, buys or sells 2 or 3 billion dollars' worth of securities. Sometimes they redeposit Treasury balances into the commercial banks, or they increase Treasury balances at the Federal Reserve. These actions increase or drain reserves, sometimes $3 or $4 billion in a week's time, so they have enormous latitude to offset the effects of this action.

If you desire, you could have a period of phasing in the reduction over a period of some weeks, to make sure there were no short-run disturbances, and that is what I would expect the Federal Reserve to do. They would make sure foreign central banks understood, and other ministries of finance in other countries understood, that they were not going to allow this to influence their target objectives for the money supply.

Mr. MCCRACKEN. I think essentially I agree with Mr. Jordan although I might word it a little differently.

I would make two points here.

First of all, I would emphasize that these are actions that are being taken to strengthen the capability of the central bank to execute monetary policy.

I recall Chairman Reuss' comments when he introduced these bills in the House. You emphasized the importance, Mr. Reuss, of our trying to achieve a greater capability to execute monetary policy and, as I see it, that is the objective of this. I think the bill which seems to be emerging here would constitute significant steps in that direction.

The second point I would make—and this reinforces Dr. Jordan's comments—is this: It certainly would be important for the Federal Reserve to emphasize that the transition to the new system is going to be handled in a way not only which minimizes any market disruptions or disturbances but certainly it is not going to be handled in a way which gives us an interlude of overly expansive monetary policies that could contribute further to the overheating of the economy.

Now, on the basic technical question of what might be the impact of this on Monday market rates and so forth and so on, I have no comments on that. I am not an expert in that area.

Mr. Crozier. You raised a question, Mr. Stanton, almost in the sense of a musing notion and I must confess in reading through some of the material, similar thoughts have crossed my mind.

I think perhaps the best all of us could hope for—if I might presume to say it—would be that you might take from the current bill item one, which has to do with letting the Fed obtain whatever information it needs, and then hope that the rest of it just goes away and the Fed forgets about having more members and Congress forgets about monkeying around with time-tested ways of operating the Federal Reserve System, and you could just have a heck of a pleasant election, come back next session and consider lots of other interesting issues.

Mr. Mitchell. The gentleman's time has expired.

Mrs. Fenwick.

Mrs. Fenwick. I am particularly interested in the competitive equity that Mr. Crozier has referred to and in the point that was raised also—I don't know if it was by Mr. Schechter or another of our witnesses—in the power of the Federal Reserve to tax. I had not regarded these reserve requirements as a form of taxation, which Mr. Mayer's statement shows them to be. It seems to me wrong that the Federal Reserve should have taxing powers. That power is supposed to rest with the House of Representatives and the Ways and Means Committee. We seem to be evading that in a most complicated and unseemly way and I am afraid Congress is going to allow it to happen all over again.

If we are going to tax the banks, we should tax the banks, it seems to me. We should say what we are going to do and do it and not hide it under some other maneuver. I am afraid we are going to do that.

We also set up a socially desirable goal which I share, which is that there should always be encouragement for those who put money in long-term home mortgages, a very important part of our whole economy, but then other banks who are willing to do that and are doing it, are not allowed the privileges of financial institutions which have another name, and that too seems to me contrary to commonsense and logic.

In other words, I know what is going to happen because Mr. Stanton has so well described it. We are going to continue regulation Q because we are up against a political reality—perhaps I am not speaking for my colleague, but this is what I see, knowing Congress. We are going to continue to do what we know we shouldn't do. We are going to continue to follow an illogical course because it has been set.

It would seem to me—and I would love to hear anybody comment—is this outrageous—that we should try once and for all to get a real banking bill which is equitable to all, which is concerned with the soundness of our currency, the safety of depositors' money and the encouragement of whatever social goals we feel are desirable in the economy.

Any institution that meets those responsibilities can have stated privileges. We don't care what their names are. Not only those privileges, but those taxing conditions.

"If you do this, you get that." "If you don't do it, there will be competitive equity."

It seems to me if we want to tax banks, we ought to tax them. If they want reserve requirements—how does it strike you that we should have universally-applied reserve requirements related to certain types of deposits and tax institutions? That might bring about the competitive equities Mr. Crozier was talking about.

I don't see that it is impossible to do such a thing. Is it desirable?

Mr. Crozier. I don't know who you are addressing, but if you would like me to respond, I think you have hit on quite a good idea and something that has proved to be an effective engine of legislative progress here in your body. That is, if you could only focus on what it is you are trying to accomplish and make that neutral as regards the institutions who might be asked to accomplish it, you would be far better off than trying to deal with these huge institutional issues, many of which cut across all sorts of different product lines.

I would say that is certainly a desirable objective and I think in isolated instances, one at a time, it would be possible for us all to accomplish that.

Mrs. Fenwick. In other words, the reserve requirements would be invested in revenue-producing securities. Then we wouldn't have to return money to the banks—the Federal Reserve wouldn't have to pay interest to the banks because they would be taxed separately and they could use whatever interest-bearing securities they had for their reserve requirements. I cannot see why we have made everything so complicated.

Mr. Crozier. One of the issues as an analogy would be that there is no specific institutional benefit for any institution over another to make a loan to finance higher education. The Congress allowed all financial institutions who wanted to take a swing at higher education to take a swing at it—there were no particular privileges for one over the other.

Mrs. Fenwick. No, but I think we could obviate that necessity for the loans, which would be a great improvement.

Mr. Schechter. I would just like to observe I do think the banking business is a unique business and involves the extension of credit and the supply of money which, by constitutional law, is something that Congress has authority over and has delegated only to the Federal Reserve to regulate, and with good reason. When we didn't have a Federal Reserve, there were institutions—as a matter of fact, reserves were in the form of securities, often Government bonds, and then when the tight money period arose and everybody had to liquidate securities, that couldn't serve the purpose because nobody wanted to buy Government bonds at that time, so I think we have to have reserves which are vault cash or noninterest bearing deposits.

That has been the way the business has functioned for 64 years now. I don't know if the Federal Reserve immediately instituted such reserves, but that is when the act was passed.

The banks have been able to grow generally.

Now, we can go at competitive equity in two ways. Either saying that the established form of regulating the banking business, by requiring such reserves—which are involved as a cost of business—is to be maintained, or we say, no, we will pay interest and disestablish this tradition and have the U.S. Treasury bear a cost.

Now, a so-called tax has been referred to as a franchise tax and it is a very good franchise because there is protection against wide-open competition. There is regulated franchising of possible competitors and branches, so there is a certain amount of protection. This is a quid pro quo because we involve the state of the economy and other people's money, which is being entrusted to these institutions and this is such a broad public interest that I think there is a right to require a certain cost of business to be borne.

Mr. Mitchell. The gentlelady's time has expired, however, I would like to hear from any other panel members who would like to comment. Are there other comments on the rather long question raised by Mrs. Fenwick? I think we should hear from the others and go right to Mr. Vento.

Mr. Mayer. With regard to instituting reserve requirements on all deposits, I think this is excellent. I think having them only on banks is a historical accident related to concerns about the safety of banks.

With regard to paying interest, by allowing the banks to hold Government securities, that is rather complex, because if you allow the banks to hold any type of securities, then the banks themselves will determine what they hold. They could go out and buy more securities and create more money. The Fed would lose very much control.

A variant possibly might be to tell the banks there are only certain Government securities which you can hold as reserves and you may deal in those.

Mr. Jordan. I think you would find that once implemented, the proposal for a uniform 6-percent reserve requirement goes a long way toward accomplishing what you would like to see.

I think it would go all the way if it were applied to all the institutions. It would be viewed as a franchise tax to those who want to be involved in the payments system, or in creating money.

When an individual goes into the grocery store and writes a draft, whether it is a NOW account or a share draft, and if the individual views that as a check, and if the grocery store construes it to be a check, and the larger thrift institutions want to participate in that business, they should be subject to the same rules.

Then you would have equity and monetary control.

Mr. MITCHELL. Mr. Vento is recognized.

Mr. VENTO. Thank you, Mr. Chairman. I have read some of the statements. I have not read Mr. Mayer's and Mr. Romberg's statements yet, but I shall.

The issues that surround us are substantial and I think as we get into looking at interests and reserves and the different types of requirements and we look at the benefits flowing therefrom, there are underlying benefits that reserve members have in terms of monetary policy, in terms of the franchise, that we have extended in terms of monetary policy. I suppose it is intangible, but it is a responsibility that exists. However, we get into the argument on whether we ought to pay interest and, surprisingly, we begin to isolate the costs and services we provided. Such as the discount window being a benefit, the services provided are an advantage or a benefit. The correspondent services are an advantage or a benefit, but the underlying one I guess that doesn't get discussed is the whole basis for the System and I suspect in order to satisfy the banks our members would like to have back the entire $6 billion they earn. That would satisfy them at the market rate.

That is a logical conclusion if you look at this as a tax, which I do not think it is. You don't offset the services provided and there are many intangible things that are provided. That is the conclusion one would be forced to and it is mistaken.

We have been through that evolution before the committee, and I am not as conversant as many of the other members may be in all of the subject matter, but I do know there are problems. We are addressing the problem of deteriorating membership and then we ought to try to deal with that. Perhaps the ambitious route is to say, "We will pay interest." That will help deteriorating membership. I am not sure that has been demonstrated.

The Chairman of the Fed and others who appeared before us got a mixed reaction with regard to that conclusion.

You talk about reserve requirements. What reserve requirements do we really need in order that the Fed can carry out its responsibility for monetary policy?

There are many problems that come up: universal requirements for every depository institution; and, of course, the suggestion about charging for services at a market rate, which I think the Fed is intent on doing. At least it is addressing itself to that. Maybe we can tie the benefits to the profits that are paid out.

Well, none of these seemed to be conclusive until the chairman and the able staff worked up the most recent proposal which I think personally is about the most straightforward, clean way to solve the problem in my judgment and eliminates all of the arguments, but I wanted to ask a few questions.

Mr. Crozier, you show the number of banks in your holding company who are in and five have now dropped out of the Fed.

You leave one bank in the Fed and you continue to use all of the services provided through your holding company. I guess that is all right, except five or six members or whatever your number is, they are no longer members, but they get all of the benefits and don't have the reserve requirements on tap. How would you respond to that criticism of bank holding companies? I didn't see any reference to that in your statement. That is a key issue with regard to bank holding companies.

Mr. CROZIER. I cannot speak on behalf of all bank holding companies, but I can say on behalf of ourselves we still use the same variety of services through correspondents and Fed channels as we did.

The proportions may vary some, but, as you are well aware, in the testimony that has been given here—and as the Fed readily admits—the value of their services comes nowhere near the amount of interest they collect on reserves, so it is not a 1 to 1 equation.

Mr. VENTO. What I tried to suggest in my remarks is that there are a lot of intangible things that go on where members receive benefits. The whole monetary structure, the whole system that exists, the way it is structured in this country. I do not think that can be measured.

Mr. CROZIER. We factored the cost of that into our analysis and as a result of that had to acquire those services at a price in other ways. That was a relevant consideration, and after all was said and done we still produced a substantial saving as a result of not being a member of the Federal Reserve System.

Mr. VENTO. I am not talking about the actual services; I am talking about the intangible items.

Mr. CROZIER. Which intangible items?

Mr. VENTO. Clearance, armored cars, financing, and so forth.

Mr. CROZIER. The only intangible item I recall having lost—if you do not mind my being a trifle facetious—is the fact they used to invite me to lunch at the Federal Reserve Bank of Boston, and I no longer get invited to lunch.

Mr. VENTO. That was not the intangible I had in mind. I thought you were going to refer to Federal Reserve membership on your board.

Mr. CROZIER. We are a stable financial institution and have been around for a long time and I hope our customers will look at the way we run our business as being the most significant aspect of that.

Mr. VENTO. I hope they do. I also think it is necessary that the role of the Fed in terms of the monetary policy, and so forth, represents a substantial intangible benefit to everyone——

Mr. CROZIER. To go back to that in a serious vein, you are certainly correct, Mr. Vento. Given any sort of reasonable economic scenario, we would eagerly rejoin the Federal Reserve System. We said that when we withdrew; we did so reluctantly. We have a deep commitment to the institutional structure of this country and would be glad to have our name associated in every way with that structure.

Mr. VENTO. We will not be able to provide a universal reserve requirement that has been discussed. The plan of the chairman and the staff is somewhat more equitable.

Let me look at some of the specifics. Mr. McCracken talked about the difference in transaction accounts and other types of checking accounts in terms of the M_1 and how that is addressed by the Fed. They actually put a different requirement on transactions as opposed to other types of demand deposits, checking accounts I guess for members, and that the committee draft has come up with a version where we have a new definition.

What is the practical effect of having that, Mr. McCracken, in that vein? And then the actual—the second question I would ask, and I prevail on my colleagues to permit me to pursue, that is the actual amount of swing in our bill, which is about $3 billion of monetary swing, if that is adequate. Just those two questions.

One other definition of demand deposits and transaction accounts in the Federal bill and what we have done putting it under the same percentage, and then the amount of swing in terms of the 6 to 7 percent that I think we provide in our proposal.

Mr. McCracken. Do you mean 6 or 7 percent swing in reserve requirements?

Mr. Vento. Is that adequate to deal with monetary policy? Is that too inflexible?

Mr. McCracken. Unless I misunderstand the question, I think that alludes to some comments I made earlier about reserve requirements.

Mr. Vento. There is a $3 billion swing in terms of reserve requirements that exist. They would have discretion if they were 6½ they could move up $2½ billion or down $1½ billion for reserve requirements.

Mr. McCracken. I am interested in that rather moderate type of change because I think open market operations could probably operate within those boundary lines. My major concern about reserve requirements is to give the System the authority for those outside contingencies, which of course we hope will not occur. In an emergency, whether a monetary panic or a flood of money coming in from abroad, or something like that, they do need to have the authority to deal with that.

In the normal course of the operation of a monetary policy, I think that 0.5 percent is ample. In fact, I think it is not really needed.

On the practical implications of these changes, our bankers here would be more expert in addressing that than I.

Mr. Vento. The transaction accounts versus the demand deposits?

Mr. McCracken. Yes. My original testimony of course was written in the context of the collection of bills. I would support the new proposal.

Mr. Vento. The general definition in terms of transactional versus demands—is there any other feeling by those who are here?

Mr. Mitchell. The Chair must interrupt the gentleman. In all fairness, Mr. Green has been here for some time. We will try to get back for further responses after he has had a chance to ask questions.

The Chair observes from time to time members of the subcommittee go to the Federal Reserve for breakfast. I will try to work up a prodigious appetite.

Mr. Green, you are recognized.

Mr. Green. I would like to return to the question of the impact of the banking system on the housing industry and housing production. We have had some discussion this morning of a differential in reserve requirement based on the kind of deposit, that is, having a reserve requirement for the immediately withdrawable deposit as opposed to no reserve requirement or some lesser reserve rquirement for time deposits, with various suggestions ranging from very short limits like 30 days out to 8-year certificates.

I am wondering whether the members of the panel would be prepared to comment also on the question of changing the reserve requirement based on housing investment, that is, lower reserve requirements to the extent that an institution has a proportion of deposits devoted to housing investment—I recognize there are those who may prefer changes in tax rates as a means of inducing housing investment, but this committee of course does not control tax rates so we can only deal with the question of reserve requirements. I would be interested in your comments on that.

Mr. JORDAN. Taking the last item first, I would not favor different reserve requirements depending on the extent to which any institution, banking or nonbanking, makes housing loans, or any other preferred type of activity. Once you start doing that, you compound the problems of monetary control. I think that 6- or 8-year savings certificates at large commercial banks, or at savings and loan associations, or at mutual savings banks, mostly are going to go into long-term assets, and that is almost always going to go to mortgages. I see no benefit in having an idle cash reserve requirement on these certificates at a bank that is making mortgages versus a savings and loan association or a mutual savings bank.

There should not be a reserve account for one, a disincentive for one, and not for the other. To say that commercial banks that do make more mortgages, or have a higher proportion of mortages, would be subject to a lower reserve requirement just introduces something—a form of credit allocation which influences incentives—that I do not think is necessary or desirable for monetary control purposes, or really for equity purposes.

There is no real evidence that any of those kinds of activities or proposals would, in fact, cause more mortgages. And even if there is more mortgage lending, that is not necessarily going to produce more housing.

In the last 2 years there has been ample evidence that people are borrowing on houses to buy a car, to take a vacation, or whatever. It is a cheaper form of credit than a personal loan or a consumer loan, and they are spending their equity. Their house has appreciated in value so they increase the first mortgage, or they get a second mortgage, and go on a fling, and that does not help the housing industry.

What you should look for are direct clear-cut measures, not backdoor measures, to help the production of housing—building more houses and apartments. That is what I think is your real objective. Better quality and lower cost housing, and not really so much mortgages per se.

Mr. McCRACKEN. I do not dissent from what Mr. Jordan said at all. Just this additional comment: this is a basic question which you have raised. It is the question of the desirability of having reserve requirements based on assets rather than on the liabilities. That is the general question. I would be skeptical about that. I would be very sure that before the committee was ready to act on that they would find that they are unearthing all kinds of extraordinarily difficult and complex questions. In other words, I would predict that between now and Monday you cannot solve those problems.

Mr. GREEN. I really asked that question for the long-term outlook and not for between now and Monday.

Mr. MAYER. It seems to me if we are going to subsidize housing we should do it in the open where it can be seen, rather than indirectly through the banks, and that this proposal would complicate monetary policy and it does interfere with free market allocation. It tells people they can get housing cheaper by borrowing than through some other means.

Furthermore, within the whole problem of subsidizing housing it would probably be better to subsidize expenditure for housing completely rather than to subsidize only mortgages. We would not want to subsidize timber or bricks used in housing, but the houses themselves. There is now evidence if you are subsidizing mortgages you are subsidizing general borrowing, and not housing production per se.

Mr. SCHECHTER. Mr. Green, I think we do have a certain amount of recognition of the need to provide funds for housing because it is generally a problem. In the savings and loan they are subject to certain hazard requirements which the banks do not have. It is not a question of whether they will go into housing. As a matter of fact, the banks have the privilege, and have exercised it, of changing their allocation of investment policy and going to higher yield investments, shorter term investments, even with the savings funds when interest rates are higher.

So I think for an institution such as the savings and loan, which has to meet the asset ratio, and it also has long-term savings accounts rather than transaction-type accounts, we do have an institution where I think there is the, what I would say, a deserved preferential treatment as far as reserves are concerned. There is no other institution really quite in that same category. The mutual savings banks are something in between the commercial bank and the savings and loan, and are approaching fast the commercial bank's status.

Mr. MITCHELL. The gentlemen's time has expired.

I suppose procedurally we will briefly go for another round of questions. We do not want to overburden you gentlemen but I am sure there are additional questions. The Chair has one, merely to clarify my own thinking.

Mr. Mayer, you made reference to a problem of the 6 percent reserve requirement occurring when a bank might want to keep 8 percent or 10 percent or more. I am not at all sure I followed you. It does not seem to make any difference. We are dealing with a proposal that says 6 percent. If they want to keep 20 percent, I do not see how they would be adversely affected.

Mr. MAYER. The problem is if the regulation states 6 percent and the bank keeps 8 percent, the 6 percent is not really binding. Then the bank might decide to go from 6 percent to 10 percent—I am sorry, from 8 percent to 10 percent, or down to 7 percent, and the Federal Reserve would not know this, and consequently all of a sudden the money supply would either shrink or expand at an unexpected rate.

Right now the Federal Reserve can use the reserve requirement to predict the money supply from the reserves the banks have. Otherwise, the Federal Reserve control would be less accurate.

Mr. MITCHELL. Thank you for your explanation. Under our proposal of reporting, it seems to me that this kind of situation would be covered because the Fed would know through the reporting system.

Mr. JORDAN. I think Professor Mayer's concern would show up only if you observed idle excess reserve balances in the Federal Reserve and that would be reported as some form of idle reserve balance. He suggests commercial banks want to hold idle cash reserves of say 7 to 8 percent on all reservable liabilities and I find that hard to believe. I do not believe it.

If the requirement were only for 6 percent, I still do not think there would be a problem of monetary control as long as the central bank is operating on total reserves of the banking system, as it should, or the monetary base.

Mr. MITCHELL. Mr. Reuss.

The CHAIRMAN. I have a very short question.

I notice the BayBank system has 12 banks, 6 of which are State nonmember banks and 6 are national banks. One of the national banks is currently being organized. Why, having come to the conclusion that it is just not a good deal to be a member of the Fed, do you go organizing a national bank? Why don't you organize a State bank?

Mr. CROZIER. That is a good question. It helps if you can visualize the distribution network of our company, if you think of Boston and you think of the arc surrounding Boston, where concentration of population in Massachusetts is, that is where we operate but not in Boston proper.

Boston is the center of the New England region for monetary purposes, for large corporate purposes, and we felt it important to have, in the city of Boston, a bank that was connected to the national banking networks. The major banks in Boston, as you probably know, are all national banks. This bank is going to be involved with communicative networks of the Federal Reserve—and be in commercial and banking intercourse throughout the Nation, and it seemed more appropriate for us to have a nationally chartered bank.

The CHAIRMAN. It will be physically situated——

Mr. CROZIER. Directly across from the Federal Reserve Bank of Boston—a somewhat more imposing structure, but we are there nevertheless.

The CHAIRMAN. You may get back in for lunch one of these days.

Mr. CROZIER. I certainly hope so.

The CHAIRMAN. I thank you for your testimony, gentlemen.

Mr. MITCHELL. Mr. Stanton.

Mr. STANTON. Just one short comment and maybe one short question. Once again to you, Mr. Crozier: We do appreciate your endorsement of our title I reporting section. The other obvious question. You know, getting back once again to this subject of the Federal Reserve membership, what level of reserve reduction might we come up with that you think would stop the attrition in the Fed membership?

Mr. CROZIER. As I pointed out in my testimony the Federal Reserve has given a lot of indications as to how they might behave without saying exactly what would happen. And you would have to rescue from that first Fed bill the ability for the Federal Reserve to move time and savings reserves down to a level of one-half of 1 percent. Incidentally, this makes good sense when you realize many of us compete against savings banks which do not have to keep any reserves.

But if you took all the indications of how the Federal Reserve is likely to behave from their legislative package and put them in the form in which I discussed in my testimony, our calculations show that the result would be very persuasive from the standpoint of rejoining the Fed and for our national banks staying in the Fed.

As I say, that is a very broad-gage cut, but we certainly think that legislation would do it.

As a practical matter, I could buy all of you a very nice lunch for the amount of money your new bill might cost us. As we roughly calculate it, the new bill would make us put up another $30 million of sterile reserves in the Federal Reserve System which we otherwise would not have to do.

You should realize that our system, as with all systems, has a certain economic equilibrium at a point of time, and there are only a few places from which a major cost increase can come: Perhaps from our customers, perhaps from the salaries of our 4,000 employees, including of course myself, perhaps by increasing the leverage of our business and increasing the risk. We do know that it can't be found in a bottom drawer someplace.

So I would say the bill you propose, as factored by the Federal Reserve indications, would provide a formulation which, if we can interpret it correctly, would do the job. For those kinds of banks which seem to be key ones in the Federal Reserve formulation, the new bill that is before the committee is really an absolute disaster.

Mr. Stanton. Instead of attacking this problem of reducing reserve levels, if you take the ratio of the reserve banks and reduce that, which is now 10 to 22 percent, to 7 and 19 percent, and the ratio for the nonreserve city bank, reduced from 7 to 14 percent, down to 4 to 11 percent, and the ratio for time deposits which range from 3 to 10 percent, down to one-half to 7 percent, which do you think would be preferable?

Mr. Crozier. I would be more than happy to take that home and play around with it. I am not sure I can come up with a ready answer.

One of the things that is appealing about the Fed's proposals, which drifts in the direction you have just described, is the fact that they undoubtedly have tested it time and again against "live" situations. It would be quite ludicrous for them to put forward a proposition that would not do the job.

I trust that they have, over and over again, in State after State, jurisdiction after jurisdiction, for different sizes of institutions, tested this formulation and have come up with something that will work. They have data with which to do that which you and I do not possess. One should have, it seems to me, a substantial amount of faith in the fact that the Fed's document is quite a thoughtful, well-researched and carefully devised plan.

I wish I could be more specific with regard to your precise dollars-and-cents question, but the drift of it seems to be in the right direction.

Mr. Mitchell. Mrs. Fenwick.

Mrs. Fenwick. Thank you, Mr. Chairman.

I have another rather simplistic question and that is: Why is a dual banking system so desirable? Chairman LeMaistre was here the other day and I asked him that question. He said, well, for the innovations that a dual banking system can provide.

The only innovation we could think of at that particular moment was the innovation of the NOW accounts which the dual banking system in New England put into practice.

What in your opinion justifies the remark that a dual banking system is so desirable?

Mr. CROZIER. Were you asking me that?

Mrs. FENWICK. Anyone who has a view. Maybe Mr. McCracken, who said something about it being so desirable. What is so desirable about it?

Mr. McCRACKEN. I am sure one could make a case in the abstract on this question of innovation, but I would not consider even that to be the core of this. I would argue this on the same basis that it is desirable to have the whole system of governments in this country somewhat dispersed. No one unit of government ought to have absolute and total control.

Mrs. FENWICK. I agree with that on uniform control. I would say that, too. But if we want a more deliberately competitive and equitable system, wouldn't that produce somewhat the same effect? In other words, if we decide to have a franchise tax, which I am not against, it ought to apply to all banks and not just the members of the Federal Reserve. Call it a franchise tax, based on size or whatever, if we decide to tax; call it a franchise tax and impose it on all banks.

It seems to me it would be logical to have reserve requirements in interest of the public. I am trying to see what is the basic structure that we ought to have in mind in trying to approach some goal. If the dual banking system produces a system of competitive equity, fine. How does it do that?

Mr. JORDAN. The fundamental purpose of having regulation and supervision of banking institutions or financial institutions is to prevent 1907-type panics. That is why the Federal Reserve was created. You want to preserve the integrity and the efficiency of the System to promote economic growth, prevent panics, and protect depositors. We do not know in these rapidly changing times of technological innovation and changing market conditions what kinds of innovations are best to serve the customer's interest and to serve the market's interest, such as the automatic clearinghouse provisions.

Different States take different approaches, because they have their own bank supervisors and bank regulations to issues such as terminals in the supermarket—are they a branch or not a branch?—and to other aspects of the point-of-sale type activity.

We see in the New England area this phenomenon of NOW accounts. In Pennsylvania we have non-interest-bearing NOW accounts.

Mrs. FENWICK. Mr. Jordan, could we not allow banks to continue to do that, with certain minimum requirements? If reserve requirements are necessary, as you say, for the economy and the safety of the depositors, establish those minimum requirements and then allow the banks to do what they want. Would that be safer?

Mr. JORDAN. I would agree if you are really going to have zero-based regulation, a minimum regulation. Once all institutions, though, are subject to the same regulator, you no longer have our system of government of checks and balances. You have to have a guarantee that that one monopoly regulator does not have the ability to start making regulations more onerous once one cannot escape from the System. The plurality aspect Professor McCracken referred to is desirable as a safety valve.

Mrs. FENWICK. If you kept the Federal Reserve, limited its powers so they could require only certain very limited things which would be essential for the economy and for the safety of the money, then all this innovation and competition could take place outside, provided those basic regulations were met.

Mr. JORDAN. I agree in principle. It says, if you are not going to regulate certain activities then the regulations which do not exist can be uniform. I agree in principle but I do not think we are going to get to that system.

Mrs. FENWICK. Why not?

Mr. JORDAN. Because between now and Monday you are not going to be able to——

Mr. MITCHELL. I am afraid we will not be able to get a full response, as the gentlelady's time has expired.

Mr. Vento.

Mr. VENTO. Thank you, Mr. Chairman.

Mr. Romberg, some brief questions with regard to the services that you provide.

Do you agree with the value that the Fed has put on service? It is not a valuation of what it would or could earn in the near future for the $410 million for services it offers—I assume you are talking about one of the services; I don't know whether you are just talking about the wire services.

Mr. ROMBERG. The wire transfer service is our particular concern.

Mr. VENTO. In exploring this, are you under a franchise agreement right now in terms of offering that particular service, or is that open to anyone to enter that marketplace?

Mr. ROMBERG. It is open to anyone.

Mr. VENTO. Are there some loopholes in the Fed wire service you would offer that would justify filling in where your services are not available or would not be available in some areas?

Mr. ROMBERG. No, our bylaws provide for membership by any financial depository institution, Fed bank or not, savings and loan or commercial bank. No restrictions.

Mr. VENTO. What do you think are the value of the services that the FedWire provides now? In general terms I understand it has to be in those terms as opposed to—what is the type market, the potential that exists there either in a reality right now or in the future?

Mr. ROMBERG. The principal competitive advantage that the Fed has is, on the one hand, that there is no charge for their service. That is substantial. Second, there is the technical subject of availability. Transfers throughout the FedWire system are made through a reserve account, and in effect users of that service are assured that funds availability would be made that day. The BankWire is seeking to have that same type of access to the Fed through settlement. However, until we have that, our service cannot in any way be competitive with the Fed.

Mr. VENTO. Does that necessitate a regulatory or franchise agreement with them or could that be entered into with any number of enterprises?

Mr. ROMBERG. It could be entered into by any enterprise but requires agreement with the Fed.

Mr. VENTO. Are there problems dealing with that issue and certain security requirements would require a role by the Fed?

Mr. ROMBERG. There are no privacy considerations I can conceive of. There are questions of credit and liability.

Mr. VENTO. Security?

Mr. ROMBERG. Not of security.

Mr. VENTO. Mr. Crozier, one question. The Fed's carefully constructed proposal would cost taxpayers nearly three-quarters of a billion dollars with most of it going to the biggest banks. Is that really justifiable?

Mr. CROZIER. You say most would go to the biggest banks. I do not know that the calculations would work out that way. They seem to be favoring the first $25 million worth of reserves with a 6-percent rate and reserves over that at 2-percent rate. You may have calculated that that means the largest amount would go to the biggest banks. I have not done that.

It strikes me that if you have a major question that can be solved in this way, $750 million is not an awful lot of money. I wouldn't dare say that around Boston but I certainly can say that down here. It strikes me that if you followed the analysis through to the number of different ways in which that money then trickles back to you through depositors or stockholders or to others who wind up essentially paying our taxes, you would find that you would get it back very, very rapidly.

Mr. VENTO. I disagree with you. We explored that possibility and our calculations indicate that does not hold up very well.

All we are asking for is $30 or $35 million in reserves. Would that not be offset by vault cash in your institutions?

Mr. CROZIER. We still would wind up after all was said and done, dishing out something over $30 million, and that is after having taken into account vault cash.

Mr. VENTO. I appreciate your responses.

Thank you, Mr. Chairman.

Mr. MITCHELL. The gentleman's time has expired.

Mr. Green.

Mr. GREEN. Let me use my time to respond to the gentlelady from New Jersey. Our experience this year with what started out as a so-called Safe Banking Act scarcely predisposes me to believe that this institution is likely to arrive at the happy state of minimal regulation that she desires.

I yield back the balance of my time.

Mr. MITCHELL. Gentlemen, thank you so much. You have been very patient with our questions and our probing, and we are most appreciative. The timing is exactly right. We now have a vote on the floor and this one I will make because I assume it is a vote of some significance.

Thank you very much for your cooperation. Today's hearing stands adjourned.

[Whereupon, at 11:40 a.m., the committee adjourned, subject to the call of the Chair.]

MONETARY CONTROL AND THE FED MEMBERSHIP PROBLEM

FRIDAY, SEPTEMBER 22, 1978

House of Representatives,
Committee on Banking, Finance and Urban Affairs,
Washington, D.C.

The committee met, pursuant to notice, at 9:10 a.m., in room 2128, Rayburn House Office Building, Hon. Henry S. Reuss (chairman of the committee) presiding.

Present: Representatives Reuss, St Germain, Annunzio, Spellman, Derrick, Hannaford, Vento, Watkins, Stanton, Brown, Wylie, Rousselot, and Fenwick.

The Chairman. Good morning. Thank you for showing up so early. We are deeply appreciative. Won't you gentlemen be seated?

Back on September 14, our committee approved H.R. 14072 by a vote of 22 to 14, a bill to improve the conduct of monetary policy and to promote competitive equality among commercial banks.

The bill is the culmination of years of discussion about the erosion of Federal Reserve membership, the gradual shrinkage of the Nation's reserve base, the difficulties of conducting monetary policy as deposits shift among different banks and different types of accounts with widely varying reserve requirements, and the competitive disadvantage of banks required to hold sterile reserves as a result of Federal Reserve membership.

The central idea of the bill—to make reserve requirements more uniform and extend them equally to all banks—is a familiar one. It has received widespread support from many groups over a long period of time.

Back in 1948, the Board of Governors of the Federal Reserve said in their annual report that they felt it was essential "that reserve requirements for all insured banks be as uniform as practicable in order to apportion basic reserves equitably in the banking system as a whole." They were endorsed again in 1950 by a congressional subcommittee chaired by the late Senator Paul Douglas, by the highly respected private Commission on Money and Credit of the early 1960's, and repeatedly in annual reports by the Federal Reserve since then. It has also received the support of such noted economists as Nobel Laureate Milton Friedman, former Chairman of the Council of Economic Advisers, Paul McCracken, and many others.

On July 14, I introduced, at the request of the Federal Reserve, H.R. 13476, requiring universal reserves for all banks, without payment of interest, with no exceptions. The American Bankers Association and many banks took advantage of the opportunity we gave the Nation's 14,000 banks to give full testimony. After hearing the witnesses at length, this committee, as I said, on September 14, reported out H.R. 14072, the bill that you are going to comment on this morning. This, of course, considerably softened the impact on banks. It drastically reduced reserve requirements; it presented a gift from the taxpayers to the banking system of the Nation amounting to a quarter billion to half billion dollars a year. It gave special consideration to the problems of smaller banks with $100 million and less in deposits.

I just find it very, very difficult to believe that the American Bankers Association was asleep at the switch and that its members can now be seriously claiming that they weren't granted full and adequate opportunity to be heard.

However, our committee wants to avoid the slightest suggestion, however unfounded, that we have not given every one of the Nation's 14,000-odd banks not only its day before the committee, but a repeat performance. Accordingly, we have invited the 14,000 banks here this morning, and some 40 have asked to testify and will be heard today.

We members of the Banking Committee generally agree that the problems associated with the erosion of Federal Reserve membership have to be addressed, that this is one problem in these days of inflation, in these days of deteriorating international dollar, that we can't conscientiously sweep under the sofa, no matter how vigorous the bellyaching of the American Bankers Association may be. We firmly reject the paying of interest on reserves for several reasons, principally because of the tremendous cost to taxpayers with most of the payments going to the Nation's largest banks at taxpayer expense. We are conscious of the disgusting budgetary deficit under which this country operates and don't wish to be a party at increasing it unduly.

We have worked in close consultation with Chairman Miller and others at the Federal Reserve Board on the bill. It is strongly supported by Chairman Miller, by the Independent Bankers Association and by many individual banks which are members of the American Bankers Association and which to their credit defy the ABA.

In my view, the public stands to gain a great deal from this bill, partly through better ability of the Federal Reserve to conduct monetary policy and avoid the excessive economic swings which have plagued our economy over the years, and partly through improved competitiveness and stability of the banking system.

Happily, it is not only the public but the great majority of banks which will benefit. All banks which hold reserves with the Fed will have their reserve requirements reduced. Some 95 percent of the Nation's banks will be completely exempt from reserve requirements. As a matter of equity, however, and to preserve the Nation's monetary base, large banks which are not members of the Fed would have to hold reserves just as large member banks do. This is a simple matter of competitive equality and justice.

It is grossly unfair today that member banks bear the burden of maintaining the Nation's reserve base.

As we said in that old song down in Memphis, "Mr. Crump don't allow no easy riders here," and that is why it is understandable that the 240 nonmember banks required by this legislation to hold reserves are not happy about it. I don't blame you. I wouldn't be happy about it, either, but this committee has to represent the Nation, not just those who have elected to have the other 14,000 American banks bear the burden of conducting a noninflationary dollar defending monetary policy.

[The text of H.R. 14072 follows:]

95TH CONGRESS
2D SESSION

H. R. 14072

IN THE HOUSE OF REPRESENTATIVES

SEPTEMBER 13, 1978

Mr. REUSS (for himself, Mr. MITCHELL of Maryland, Mr. MOORHEAD of Pennsylvania, Mr. GONZALEZ, Mr. ANNUNZIO, Mr. FAUNTROY, Mr. BLANCHARD, Mr. LAFALCE, Mrs. SPELLMAN, Mr. LUNDINE, Mr. PATTISON of New York, Ms. OAKAR, Mr. VENTO, Mr. GARCIA, Mr. WYLIE, Mrs. FENWICK, Mr. GREEN, and Mr. DERRICK) introduced the following bill; which was referred to the Committee on Banking, Finance and Urban Affairs

A BILL

To facilitate the implementation of monetary policy and to promote competitive equality among commercial banks.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That this Act may be cited as the "Federal Reserve Act Amendments of 1978".

REPORTING REQUIREMENTS

SEC. 2. Section 10 of the Federal Reserve Act is amended by adding at the end thereof the following new paragraph:

"The Board may require any depository institution specified in this paragraph to make, at such intervals as the Board may prescribe, such reports of its liabilities and assets as the Board may determine to be necessary to enable the Board to discharge its responsibility to monitor and control monetary and credit aggregates. Such reports shall be made (1) directly to the Board in the case of member banks and in the case of other banks whose required reserves are greater than zero, and (2) to the Board through (A) the Federal Deposit Insurance Corporation in the case of insured State nonmember banks, (B) the National Credit Union Administration in the case of insured credit unions, (C) the Federal home Loan Bank Board in the case of any institution insured by the Federal Savings and Loan Insurance Corporation or which is a member as defined in section 2 of the Federal Home Loan Bank Act, and (D) such State officer or agency as the Board may designate in the case of any other type of bank, savings and loan association, or credit union. The Board shall endeavor to avoid unnecessary burdens on reporting institutions and the duplication of other reporting requirements, and any date therefrom shall be made readily available to the Board. The Board may classify depository institutions for the purposes of this paragraph, and may impose different requirements on each such class.".

RESERVE REQUIREMENTS

SEC. 3. Section 19(b) of the Federal Reserve Act (12 U.S.C. 461(b)) is amended to read as follows:

"(b)(1) On the effective date of this subsection, a bank subject to reserve requirements shall maintain reserves against—

"(A) the total of its demand deposits, savings deposits, and deposits subject to negotiable order of withdrawal that exceeds $50,000,000 in the ratio of 7 per centum, and thereafter, in such other ratio not greater than 8 per centum and not less than 6 per centum as the Board may by regulation prescribe solely for the purpose of implementing monetary policy; and

"(B) the total of its time deposits with initial maturities of one hundred and seventy-nine days or less in the ratio of 6 per centum, and thereafter, in such other ratio not greater than 6 per centum and not less than 1 per centum as the Board may by regulation prescribe solely for the purpose of implementing monetary policy; and

"(C) the total of its time deposits with initial maturities of one hundred and eighty days or more in the ratio of 1 per centum, and thereafter, in such other ratio not greater than 3 per centum, and not less than 1 per centum as the Board may by regulation prescribe solely for the purpose of implementing monetary policy.

Reserve requirements imposed under authority of State law shall not be applicable to any member bank, nor to any bank whose required reserves are greater than zero.

"(2) On the effective date of this subsection, reserve requirements imposed by paragraphs (1)(B) and (1)(C) shall apply only to that portion of the sum of a bank's time deposits, regardless of maturity, which exceeds $50,000,000, and the $50,000,000 exemption shall be apportioned between the bank's deposits described in paragraph (1)(B) and its deposits described in paragraph (1)(C) in proportion to the respective amounts of such deposits at the time required reserves are determined.

"(3)(A) Each year, after the effective date of this subsection, the Board, in accordance with rules and regulations as it may adopt, shall determine the level of the total of demand, savings, and negotiable order of withdrawal deposits, and the level of time deposits, that shall not be subject to the reserve requirements prescribed by the Board. Such levels shall be determined such that the proportion of the total of demand, savings, and negotiable order of withdrawal deposits and the proportion of total time deposits at banks whose reserve requirements are in excess of zero do not change from the proportions of such totals on June 30, 1978.

"(B) In determining such levels for the coming year, the Board shall use data obtained during the prior year from call reports submitted by all banks. The Board of Directors of the Federal Deposit Insurance Corporation shall notify the Board as to which nonmember banks shall be subject to the reserve requirements of this Act after the Board has determined the levels of deposits that shall not be subject to reserve requirements.

"(4) Any reference in this Act to member banks with respect to any requirement or authority relating to reserves required by this section shall be deemed to apply to all banks which are actually required to maintain reserves under paragraph (1) or (6) of this subsection.

"(5) Any bank shall be subject to reserve requirements, if—

"(A) it is neither a savings bank nor a mutual savings bank as defined in sections 3(f) and 3(g) of the Federal Deposit Insurance Act, and

"(B) it is either an insured bank as defined in section 3(h) of the Federal Deposit Insurance Act or a bank which is eligible under section 5 of that Act to make application to become an insured bank.

"(6) If the Board determines that such action is necessary to the implementation of monetary policy, then in addition to any reserves required to be maintained pursuant to paragraph (4) of this subsection, any bank subject to reserve requirements shall maintain reserves in such ratios as the Board may prescribe against—

"(A) net balances owed by domestic offices of banks in the United States to their directly related foreign offices and to nonrelated foreign banks, and

"(B) loans to United States residents made by overseas offices of banks with offices in the United States.

"(7) Nothing in this subsection shall affect the authority of the Board to impose conditions and requirements on foreign offices of member banks under section 25 of this Act (12 U.S.C. 601–604(a)).

"(8) During any period that a bank is maintaining reserves pursuant to paragraph (4) of this subsection, such bank shall be entitled to all the privileges of membership in the Federal Reserve System except that, if it is not otherwise a member, it may not hold stock in, or vote for any director of, a Federal Reserve bank.

"(9) A nonmember bank which is subject to reserve requirements but whose reservable liabilities do not exceed zero shall be entitled to the same discount and borrowing privileges as member banks.

"(10) Upon a finding by at least five members of the Board after consultation with appropriate committees of Congress that extraordinary circumstances require such action, the Board may impose reserve requirements outside the limits otherwise prescribed by this section for a period not exceeding thirty days but which may be extended for further periods not exceeding thirty days by such affirmative action by the Board in each instance. The Board shall promptly transmit to the Congress a report of any exercise of its authority under this subsection and the reasons for such exercise.

"(11) With respect to any bank that is not a member of the Federal Reserve System on August 1, 1978, the required reserves imposed pursuant to this section on the effective date of this subsection shall be reduced by 75 per centum during the first year that begins after the effective date, 50 per centum during the second year, and 25 per centum during the third year.

"(12) With respect to any bank that is a member of the Federal Reserve System on August 1, 1978, the amount of required reserves imposed pursuant to this section on the effective date of this subsection that exceeds the amount of required reserves maintained by the member institution during the reserve computation period immediately preceding the effective date of this subsection may, at the discretion of the Board and in accordance with such rules and regulations as it may adopt, be reduced by 75 per centum during the first year that begins after the effective date, 50 per centum during the second year, and 25 per centum during the third year.

"(13) In order to provide for an orderly transition period, the Board shall implement the reserve requirements imposed by this Act for member banks in not more than twenty-four months after the effective date of this subsection.".

AUTHORITY OF STATE BANK SUPERVISORS

SEC. 4. Nothing in this Act or in the amendments made by this Act shall be construed in derogation of the authority of any officer or agency of State over any institution organized or existing under the laws of such State.

COMPOSITION OF RESERVES

SEC. 5. Section 19(c) of the Federal Reserve Act (12 U.S.C. 461(c)) is amended to read as follows:

"(c) Reserves held by any bank to meet the requirements imposed pursuant to subsection (b) of this section shall be in the form of—

"(1) balances maintained for such purposes by such bank in the Federal Reserve bank of which it is a member or at which it maintains an account. However, the Board may, by regulation or order, permit banks to maintain all or a portion of their required reserves against their transaction accounts in the form of vault cash: *Provided,* That such proportion shall be identical for all banks; and

"(2) balances maintained by a nonmember bank in a member or nonmember bank that maintains reserve balances at a Federal Reserve bank: *Provided,* That such member or nonmember bank maintains such funds in the form of balances in a Federal Reserve bank of which it is a member or at which it maintains an account. Balances received by a member or nonmember bank from another bank that are used to satisfy the reserve requirement imposed on such bank by this section shall not be subject to the reserve requirements of this section imposed on such bank and shall not be subject to assessment imposed on such bank pursuant to section 7 of the Federal Deposit Insurance Act (12 U.S.C. 1817).".

FEDERAL FUNDS MARKET STUDY

SEC. 6. (a) The Board of Governors of the Federal Reserve System shall conduct a study of the Federal funds market and the market for borrowings arising from agreements to repurchase direct obligations of, or obligations that are fully guaranteed as to principal and interest by, the United States or any agency thereof, and transmit its findings and recommendations to Congress within nine months after the date of enactment of this Act.

(b) The Board's study under subsection (a) shall include an examination of how the Federal funds and repurchase agreement markets operate, the effects such borrowings have upon the monetary aggregates, and the likely effects that reserve requirements on Federal funds and repurchase agreements would have upon the operations of financial institutions, the competitive structure of financial markets, and the market for securities of the United States and its agencies, and shall make recommendations concerning imposition of reserve requirements on Federal funds and repurchase agreements.

RESERVE REQUIREMENTS STUDY

SEC. 7. The Board of Governors of the Federal Reserve System shall conduct a study of the likely long-run effects of imposing the reserve requirements established pursuant to the amendments made by this Act on savings deposits at commercial banks and transmit its conclusion and recommendations to Congress within nine months after the date of enactment of this Act. The study shall include an examination of the likely effects such reserve requirements may have upon operations of financial institutions and upon the competitive structure of financial markets, and recommend alternatives for distinguishing between savings deposits that are used for transaction purposes and those used for thrift purposes, including procedures for imposing different reserve requirement ratios on such savings deposits.

SEC. 8. The Board of Governors of the Federal Reserve System shall conduct the following studies:

(1) A study of the feasibility and impact of permitting member banks to invest a percentage of their required reserves in United States Treasury securities, and at the same time, repealing the prohibition on the payments of interest on demand deposits. The study shall examine the impact of such an arrangement on—

(A) monetary and financial conditions;

(B) Treasury revenues;

(C) safety and soundness of member banks;

(D) impact of benefits and costs of membership in the Federal Reserve System.

The Board shall transmit its findings and recommendations to Congress within nine months after the date of enactment of this Act.

(2) A study of the feasibility and the likely long-run effects of imposing reserve requirements similar to those established pursuant to the amendments made by this Act on transaction deposits at thrift institutions

and transmit its conclusions and recommendations to Congress within nine months after the date of enactment of this Act. The study shall include an examination of the likely effects such reserve requirements may have upon operations of financial institutions and upon the competitive structure of financial markets.

(3) A study of the use of savings deposits at commercial banks for transaction purposes via prearranged or other automatic transfer to demand accounts and transmit its conclusions and recommendations to Congress by November 1, 1983. The study shall include an examination of alternatives for distinguishing between savings deposits that are used for transaction purposes and those used for thrift purposes, including different reserve requirement ratios and different interest rates payable on such savings accounts.

PRICING OF SERVICES

SEC. 9. (a) The Federal Reserve Act is amended by inserting after section 11 the following new section:

"SEC. 11A. (a) Not later than July 1, 1979, the Federal Reserve System shall have prepared and shall publish for public comment a set of pricing principles in accordance with this section and a proposed schedule for fees for Federal Reserve bank services.

"(b) The Federal Reserve bank services to banks which shall be covered by the schedule of fees under subsection (a) are—

"(1) currency and coin services;

"(2) check clearing and collection services;

"(3) wire transfer services;

"(4) automated clearinghouse services;

"(5) settlement services;

"(6) securities safekeeping services;

"(7) any new payment services which the Federal Reserve System provides, including but not limited to payment services to effectuate the electronic transfer of funds; and

"(8) any other services which the Board so decides to cover.

"(c) The schedule of fees prescribed pursuant to this section shall be based on the following principles:

"(1) All Federal Reserve bank services covered by the fee schedule shall be priced explicitly and competitively.

"(2) All Federal Reserve bank services covered by the fee schedule shall be available to nonmembers and such services shall be priced at the same fee schedule applicable to member banks, except nonmembers shall be subject to any other terms that the Board may determine are applicable to member banks.

"(3) Over the long run prices shall be established on the basis of all direct and indirect costs actually incurred in providing the services priced, including overhead, and an allocation of imputed costs that take into account the taxes that would have been paid and the return on capital that would have been provided had the services been furnished by a private business firm, except where the Board determines that the public interest requires a departure from this principle, after giving due regard to competitive factors and the provision of an adequate level of services nationwide.".

EFFECTIVE DATES

SEC. 10. (a) The amendment made by section 2 of this Act shall take effect on the first day of the sixth calendar month which begins after the date of enactment.

(b) The amendments made by section 3 and section 5 of this Act shall take effect on July 1, 1979, or such earlier date as may be designated by the Board of Governors of the Federal Reserve System.

The CHAIRMAN. Most of you are here today to represent such banks, and we are most happy to give you this opportunity to express your views. I can promise you, speaking only for myself as chairman, that I shall back to the full in the subsequent legislative history of this bill any amendments that you may suggest that are in the public interest.

Each of you has presented a statement, and under the rule, without objection, those will be received in full in the record, and we are going to shortly call on each of you.

I new would like to turn to the distinguished ranking minority member, Mr. Stanton, of Ohio.

Mr. STANTON. Thank you very much, Mr. Chairman.

Gentlemen, I appreciate this opportunity to further consider the question of the membership in the Federal Reserve System. First, I want to especially extend my own personal warm thanks and appreciation for your testimony and appearance here this morning. As the chairman has said, this legislation has come upon us—to many of us—quite quickly, and so I look forward to many of you expressing the view that many of the minority members have, that there are several areas which really do deserve careful analysis before the legislation proceeds any further.

The committee needs a better understanding of the pricing of Federal Reserve services, the implication of the committee bill for the dual banking system, the potential impact of the legislation on the Federal banking regulatory structure and the effects of the correspondent banking network.

Mr. Chairman, my interest in this legislation was really prompted early last spring, in fact, probably late winter, by a committee staff study that was done on this subject by a member of our minority staff, Ms. Charlotte Goldsten. Mr. Chairman, I would like unanimous consent now that perhaps this study could be put in the record.

The CHAIRMAN. Without objection, the study will be included.

[The study referred to by Congressman Stanton follows:]

The Decline of Federal Reserve Membership: Its Implications and Proposed Solutions

Statistical evidence compiled by the Federal Reserve indicates that both the percentage of banks belonging to the Fed and the percentage of gross deposits held by members have dropped significantly since 1965. (This decline reflects several factors: (1) newly chartered banks selecting non-member status; (2) members merging with non-members; and (3) voluntary withdrawals from the system by member banks.)

The potential implications resulting from a continued decline in Federal Reserve membership are also numerous. It has been suggested that: the Fed's monetary control will be weakened; the nation will face high liquidity risks; the Fed will lose its predicting and target capabilities, and a substantial loss to Treasury revenues will be experienced. Others contend that few, if any, problems would accrue as a result of serious decreases in membership. Nevertheless, the consensus is that the Federal Reserve as an institution is well worth preserving.

This Committee staff paper provides an objective analysis of: the burdens and benefits of Federal Reserve membership; statistics on the recent membership decline; the possible causes and effects of the withdrawals; and proposed "solutions" to arrest the membership attrition. In addition, recommendations are offered for avoiding further decline.

Charlotte Goldsten
Professional Staff Member
Minority Staff
House Committee on Banking, Finance
and Urban Affairs

February 1978

Summary

The decline in Federal Reserve membership is currently an area of great concern both to the Federal Reserve and Congress. The attached paper analyzes the burdens and benefits of Fed membership; the causes and implications of the Fed's loss of membership; and the pros and cons of proposals offered as solutions to this problem.

As members of the Federal Reserve System, banks enjoy certain advantages. Among these are: access to the discount window; free check collection and wire transfer of funds; free currency and coin shipments; and the Fed's research and educational facilities. The obligations of Fed membership most significantly include: maintaining cash reserve requirements; purchasing Federal Reserve stock; and being subject to the regulatory scrutiny of the Federal Reserve.

Statistical evidence compiled by the Federal Reserve indicates that both the percentage of banks belonging to the Fed and the percentage of gross deposits held by members have dropped significantly since 1965. (This decline reflects several factors: (1) newly chartered banks selecting non-member status; (2) members merging with non-members; and (3) voluntary withdrawals from the system by member banks.) While many explanations have been offered for the loss of Fed membership, the monetary costs of membership (chiefly, reserve requirements) is the reason most frequently cited. Other factors listed as contributing to the decline include: the impact of NOW Accounts, the availability of comparable services from correspondents; and the high capital requirements and other regulatory burdens imposed by the Federal Reserve.

The potential implications resulting from a continued decline in Federal Reserve membership are also numerous. It has been proposed that: the Fed's monetary control would be weakened; the nation would face high liquidity

risks; the Fed would lose its predicting and target capabilities, and a substantial loss to Treasury revenues would be experienced. Others contend that few, if any, problems would accrue as a result of serious decreases in membership. Nevertheless, the consensus is that the Federal Reserve as an institution is well worth preserving.

Efforts to arrest the downward trend in membership take a variety of forms and have a wide range of (or lack of) support. The proposal currently receiving the most support would authorize the Federal Reserve to pay interest on its reserves. Uniform reserve requirements (i.e., mandatory Federal Reserve membership) for all depository institutions is the approach considered by the Fed to be the "best and most simple solution." Another suggestion allows for decreasing reserve requirements to the point at which they would cover the cost of system services. Also, pricing of system services has been proposed.

It would seem the most (and politically feasible) desirable solution to "solve" the membership problem would be to couple interest payment on reserves with explicit pricing of Fed services. As a combined cost/benefit approach, this would enable members to be paid for reserves they kept, in exchange for charges for exactly those services they receive. As a supplement, allowing members to invest a portion of their reserve requirements in Treasury securities would also help to relieve the cost burden of membership, and hopefully halt attrition from the Federal Reserve System.

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> The loss of membership to the Fed is not because banks want a different set of regulations, or easier examinations, or anything associated with ulterior motives. Rather, the decisions are reached on one pure and simple basis -- cost.[1]

I. Introduction.

Declining Federal Reserve membership has become a topic of increasing concern to the Federal Reserve and Congress. During the first nine months of 1977 alone, fifty-nine banks (35 national and 24 state-members) with assets totalling over $4.7 billion have withdrawn,[2] thus continuing a trend which has been developing since World War II.

Whether or not this decrease in Fed membership causes a serious problem for the implementation of monetary policy or other areas of jurisdiction of the Federal Reserve is subject to dispute; and depending on one's viewpoint, the necessity for and type(s) of solutions required will vary. Nevertheless, it is certainly worth studying -- as most would agree that some sort of central banking structure, such as the Federal Reserve System, is an essential element in the operation of our national economy. The following is a review of the burdens and benefits of Federal Reserve membership; statistics on the recent membership decline; and the possible causes and effects of the withdrawals; proposed "solutions" to arrest the membership attrition; and recommendations for future reforms.

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1 Fred Lawson, "Now Is Already Late To Change Federal Reserve Requirements," Banking, March 1977, p. 70.

2 November 16, 1977 letter from Ken Guenther, Assistant to Board of Governors of the Federal Reserve, to Mercer Jackson, Minority Staff Director, Committee on Banking, Finance and Urban Affairs, House of Representatives.

II. Burdens and Benefits of Federal Reserve Membership

Federal Reserve membership includes national banks, and those state-chartered banks which elect to become members. When banks join the system, they are entitled to use all the system's facilities which include: (1) access to the discount window - i.e., short term borrowing from the Federal Reserve Banks, when temporarily in need of funds; (i.e., this direct access to available funds enables member banks, especially the larger ones, to serve as correspondents -- an additional and often very profitable "benefit" of membership); (2) free check collection as well as settling of clearing balances and wire transferring of funds to other cities -- largely through the Fed's automated clearing house system (ACH); (3) obtaining currency and coin free of charge; (4) sharing in the Fed's wealth of research and educational facilities; (5) participation in the election of six of the nine directors of the Federal Reserve Bank of their district; and (6) receiving dividends on their Federal Reserve Stock. In addition, there is some degree of prestige attached to membership.

Certain obligations also accompany Fed membership. Most significantly, members must maintain sufficient monetary reserves, within certain legal limits, as required by the Board of Governors. Currently, member banks must hold reserves against net demand deposits (equivalent to gross demand deposits less: cash items in process of collection and demand balances due from domestic banks), as well as against time and savings deposits, according to a schedule established by the Fed. The current reserve schedule is found in Table 1 (see Appendix). Of great importance is the fact that these reserves must be held in the form of either vault cash or non-interest bearing reserve balances at Federal Reserve Banks.

Secondly, to become members of the system, a bank must purchase stock in the Federal Reserve Bank of its district equal to 6% of its own capital stock and surplus, of which 3% must be paid-in capital and 3% subject to call by the

Board of Governors. These shares do not carry voting power to control the Board's management; however, they do pay a 6% annual dividend on the value of paid-in stocks.

Other obligations of member banks include: remittance at par for checks drawn against them when presented by a reserve bank for payment, and compliance with various federal laws, regulations, and conditions of membership under Fed jurisdiction regarding adequacy of capital, mergers, branching, bank holding company activities, interlocking directorates, and loan and investment limitations. In addition, all state chartered member banks are subject to general supervision and examination by the Federal Reserve System. (National banks are examined by the Comptroller of the Currency; state member banks are also examined by state banking authorities, as well as the Fed.)

The advantage of "non-membership" lies chiefly in the fact that non-member banks must adhere to the reserve requirements set by their respective state legislation and/or state banking authorities. These state reserve requirements may vary greatly from federal requirements in terms of the deposit base against which reserves must be held, the percentage requirements, and most notably the form in which these reserves may be held. Also, the enforcement procedures vary from state to state, increasing the difference in effective requirements.

All states, except Illinois, require reserves against demand deposits, and all but four require reserves against time and savings deposits. In determining the base against which reserves are computed, some states allow no deductions from the reserve base, while several permit deductions for all government deposits. Only two states figure net demand deposits identically to the Fed procedures. Percentage requirements range from levels below the Fed's to a maximum of 27% against demand deposits (Vermont) and 20% against time and savings deposits (Florida). Seventeen states have graduated (by size of institution) reserve requirements.

In terms of the composition of the reserves all states permit inclusion of currency and coin as well as demand balances due from domestic (correspondent) banks -- either collected or uncollected. In addition most states allow cash items in process of collection to be counted. Thus, the reserve cash burden is lessened for many smaller banks, as the balance they maintain in exchange for correspondent services (especially check clearing) are eligible to meet state reserve requirements. For larger banks, their large numbers of cash items in collection significantly lessen their costs in terms of the base for computation of required reserves.

Most significantly, the "burden" of state reserve requirements for non-members is lessened by the fact that twenty-three states allow non-members to meet part or all of their reserve requirements by holdings of U.S. and/or state and municipal securities - eliminating the idle cash balances required by Fed members, and therefore effectively reducing reserve requirements. In addition, two-fifths of the states have no penalty for insufficient reserves, and many states monitor their banks less frequently than does the Fed.

Non-members also enjoy access to the Federal Reserve System's checking services by maintaining correspondent accounts at member banks; and loans may also be obtained through correspondents. Thus, for those banks who may have low capital, non-par checking, and do not wish to be submitted to Federal Reserve examination, non-membership offers several benefits, with few of the costs of Federal Reserve membership.

III. Statistics on Decline in Membership.

Statistical evidence illustrating the recently accelerated decline in Federal Reserve membership has been prepared by the Federal Reserve staff in its June 1977 study on "The Burden of Federal Reserve Membership, NOW Accounts, and the Payment of Interest on Reserves." As shown in Table 2 (see Appendix), both the percentage of member banks and the percentage of gross deposits held by members have dropped significantly since 1965. Member gross deposits have declined 9% since 1965 (from 84 to 75%) as compared to a 3% decline (from 85 to 82%) between 1950 and 1965. The Fed also estimates that member gross deposits have decreased almost a full percentage point in the first five months of 1977. An increasing decline in membership is illustrated by the 5.6% decrease (45.1 to 39.5) since 1965, compared to only a 3.6% decrease between 1950 and 1965.

The decline in the proportion of total deposits held by member banks reflects several factors: (1) de novo banks selecting non-member status - i.e., since 1970, over 1,100 of the 1,700 new chartered banks (65%) have opted not to join the Federal Reserve; (2) members merging with non-members - 75 member banks have given up system membership via mergers since 1970;[3] and perhaps most significantly, (3) voluntary withdrawal from the system, chiefly by smaller banks - Federal Reserve statistics (see Table 3 in Appendix) reveal that between 1970 and May 1977, 403 banks left the system; and of these withdrawing banks, 85% had deposits less than $50 million, and 40% had deposits less than $10 million. Since 1972, however, larger banks (with deposits over $100 million) have begun to withdraw - emphasized by the fact that in the first 5 months of 1977, 13 banks of this size, the most in this category to withdraw in any one-year to date, became non-members, representing a $3 billion exodus in total deposits held by Fed member banks.

It is important to note, here, that net membership figures (i.e., taking into account both the number of banks leaving, and entering the system) do not reflect the continued sharp decline in membership. Statistics revealed by Senator Proxmire and confirmed by Fed Chairman Burns in Senate Hearings on "NOW Accounts, Federal Reserve Membership and Related Hearings" held in June 1977, indicate a net membership loss in 1971 and 1972; a 31-bank increase in 1973,

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3 John Paulus, Board of Governors of the Federal Reserve System, "The Burden of Federal Reserve Membership, NOW Accounts, and the Payment of Interest Reserves," June 1977, p. 2.

an increase in member banks in 1974 and 1975, and a net loss in 1976.[4] Both gentlemen agree the more significant figure, as pointed out by Dr. Burns, is the fact that from 1950 to the present, the percentage of deposits in the Federal Reserve System has dropped from 80% to 73%. Furthermore, in New England alone, during the first five months of 1977, there was a drop from 70% to 63% of total deposits.

IV. Possible Causes of Membership Decline.

Numerous factors have been set forth as possible explanations for the Federal Reserve membership decline. Nearly all agree that the cost burden is the primary reason; however, statistical estimates of these costs differ, depending on the methodology used by various groups. The American Bankers Association finds that the motivating factors behind the Fed's declining membership "boils down to the fact that membership in the Fed has proven to be a costly burden for many banks."[5] To compute the "cost" of membership, the ABA calculates the earnings which could be accrued from reserves maintained at the Federal Reserve - i.e., as non-members, banks could invest these funds in government securities and/or maintain correspondent balances. Using this approach, the ABA estimates member banks could have earned $1.5 million more in 1975 and $1.3 billion in 1976.[6]

The Federal Reserve concurs that the monetary burden of membership is the most important factor in the decline, but defines the burden of membership as "the difference between the opportunity cost of idle reserves and the value of services provided by the system for which no explicit charge is made."[7] Allowing for adjustments for Federal Reserve services provided, the Fed estimates that members held $10 billion in excess reserves in 1976. The subsequent lost

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4 U.S. Senate, Committee on Banking, Housing and Urban Affairs, Hearings on NOW Accounts, Federal Reserve Membership and Related Issues (95th Cong., 1st Session), June 20, 21, 22, and 23, 1977, p. 44. (Hereafter referred to as Fed Hearings.)
5 Fed Hearings, p. 162.
6 Ibid., p. 170.
7 Fed Study, p. 10.

revenue to member banks is found to be between $430 and $590 million, or 7 to 10 percent of domestic bank pre-tax earnings.[8] This burden is larger for smaller banks because of their less extensive use of system services -- i.e., the Fed estimates the burden of membership ranging from 14 - 19% of 1976 earnings for member banks with deposits less than $10 million, 9 to 14% for those with less than $1 billion in deposits, and 3 to 5% for banks with over $1 billion in deposits.[9]

A comparison of the Fed's estimates on earnings and membership with size of bank is presented in Table 4 (see Appendix). From this table, one concludes that between 1970 - 1976, withdrawals by bank size have been rapidly proportional to the earnings disadvantage experienced; hence, the smaller the bank, the greater earnings disadvantage experienced, and the greater of percentage of banks withdrawing from the system.

Some studies have found, however, that withdrawing banks, may not in fact realize these potential "lost" earnings. A 1975 Texas study concluded that profitability is not affected by membership because the evidence does not show a rate of return on capital that is lower at member banks, nor have profits of withdrawing banks improved.[10] Instead, member banks often account for their higher costs by passing on Fed membership burdens to the community in the form of higher prices and a lower quantity of bank services. It must be emphasized, however, that the State of Texas maintains high reserve requirements. Other

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8 Ibid., p. 65.
9 Ibid., p. 66. The Fed bases these figures on 1976 cash asset holdings of member and non-member banks. Accurary of estimates of the "burdens" range from bank to bank, according "to interest rates, the Federal Reserve requirement structure, each bank's deposit base, and the kind of system services employed."
10 Donald R. Fraser, "Fed Membership and Bank performance: the evidence from Texas," Journal of Finance, May 1975.

studies have found that profitability does in fact increase after Fed withdrawal; however, their conclusions reflect the effect of the study state's reserve requirements - i.e., the higher the level of state reserve requirements, the lower the profits reaped from non-membership.

Whether or not non-member status increases profitability, bankers believe they can attain higher earnings through withdrawal from or remaining outside of the Federal Reserve System. A 1977 Survey of "Banker Attitudes Toward the Federal Reserve System" appearing in the Summer 1977 Journal of Bank Research provides interesting insights into 600 commercial banks' (200 in each of the following categories) motives for (1) withdrawing from the Fed, (2) remaining Fed members (current members), (3) abstaining (non-members) from Fed membership.[11] A summary of the results of the survey indicate that for all three groups, access to the discount window and free currency shipments from regional Fed banks were the only consistently cited advantageous aspects of Fed membership. Free shipments of coin and currency were of somewhat lesser importance to member banks than to non-members (including withdrawing banks). Thirty-six percent of withdrawing members regarded it as the most important advantage of Fed membership, compared to only 31% of bankers never belonging, and 15% of the members. Access to the discount window was cited as the most important of advantage of the system by 46% of the members bankers, and 40% of withdrawing bankers, and by only 24% of never-member institutions.

Reserve requirements were far and away the most important disadvantage to all three groups of banks. Nearly 75% of non-member banks, 76% of the members, and 90% of withdrawing institutions cited this as the key liability of the system, with the withdrawing banks giving reserve requirements as the chief

11 The sample was stratified in all three categories by state and size of institution in an effort to draw a representative percentage composition for the group in terms of both size and location in each state.

reason for their leaving the Fed. The availability of comparable services from correspondents was also an important disadvantage to all three groups (though less so for non-members), followed by a fairly consistent negative response to the Fed's high capital requirements.

Most withdrawing banks felt that by leaving the Fed to operate under lower state reserve requirements, the earnings of the bank would improve. Furthermore, following their withdrawal, the majority indicated they did in fact attain higher earnings. Withdrawing banks also placed great emphasis (in listing disadvantages of belonging) on: the ability of non-members to borrow from the Fed; and the fact that membership may improve the operation of the system as a whole, but not necessarily that of their individual bank. A substantial number of banks currently members showed interest in leaving the system.

Among the banks who have never been Fed members, it was cited that the present disadvantages of Fed membership outweigh the merits of their joining the system and incurring reserve requirements and other burdens. Many felt correspondent banks can provide necessary services more efficiently (i.e., currency shipments, short-term loans, check clearing, etc.), and that Fed examinations and required reports provide additional unwarranted burdens.

The belief that higher earnings can be achieved is most evident in the New England area where withdrawals have been increasing even more rapidly. The Federal Reserve has labeled the impact of NOW Accounts, i.e., higher and possible pressure on bank earnings, as the major contributor to the membership problems in that part of the country. According to former Chairman Burns

> The burden of membership has been causing banks to leave the Federal Reserve System at an accelerating rate, and the New England experience indicates that nationwide NOW Accounts will probably accentuate the withdrawal trend.[12]

Statistics on membership decline have been more severe in the New England area than in the rest of the nation. Between 1974 and 1976 New England member deposits declined 4%, in comparison to a 3.2% national decline; and in the first five months of 1977, New England member deposits decreased 7%,[13] as against the Fed estimate of 1% for nationwide membership. Table 5 (see Appendix) provides the Federal Reserve figures on national membership and membership in Massachusetts and New Hampshire, the earliest states to have NOW's. From the table, one notes that in most years since 1972, when NOW Accounts were first authorized in those states, a larger membership decline was evidenced in Massachusetts and New Hampshire than in the nation as a whole.[14]

The composition of the New England withdrawing banks is of additional concern to bank regulators. In the first five months of 1977, one quarter of the withdrawing institutions were located in New England. Of these, nine banks had deposits of over $100 million.[15] Thus, of the 42 New England commercial banks with deposits exceeding $100 million, only 16 are still members of the Federal Reserve; and Frank Morris, President of the Federal Reserve Bank of Boston, states that 10 of these remaining members are considering withdrawing from the system. Morris predicts, "if nothing is done," it is probable that by 1979, 86% of the large New England commercial banks whose deposits total $8.7 billion, will be non-members.[16]

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12 Fed Hearings, p. 35.
13 Ibid., p. 13.
14 Ibid., p. 46.
15 Fed Study, p. 6.
16 Fed Hearings, p. 443.

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Although the loss of bank earnings attributable to NOW Accounts in Massachusetts and New Hampshire are placed at 3.5% for 1974 and 7.5% in 1975,[17] other factors are contributing to a decline in earnings, most notably large provisions for loan losses in New England.[18] Whatever the reason for earnings reductions, banks have been induced to seek ways to lower their costs and increase their earnings. In his statement at the Fed Hearings, James Duesenberry, Professor of Economics, Harvard University, assessed the New England situation as follows:

> I think what has happened is that basically membership has not been profitable to a large class of banks for a long time, but prestige, custom, things like that make them ride along until suddenly they find that they are under profit pressure. The underlying problem is the unprofitability of membership. Because if it were profitable to be a member, then competitive pressure won't push you out.[19]

Thus, NOW Accounts have acted as a catalyst, and not the underlying causal factor of membership decline.

Recent committee correspondence with Bay Banks, Inc., a $1.8 billion (in deposits) Boston-based bank holding company that withdrew from the Federal Reserve in Spring 1977, supports Professor Dusenberry's analysis of the role of NOW Accounts in the membership decline. Mr. William Crozier, Jr., Chairman of the Board and Chief Executive Officer, describes the Bay Banks' experience as follows:

> When all is said and done, the NOW account was the motive force behind withdrawal. The costs of membership seem always to have outweighed the benefits; and for years, many of us, when riled by that notion, would argue that the Fed should either lower the costs or raise the benefits -- not just to us but to the industry as a whole. Nevertheless, we labored on (rather cheerfully, I might add) in the face of shiny new Fed head-

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17 Ibid., p. 40.
18 Fed Study, p. 6.
19 Fed Hearings, p. 792.

quarters' buildings, pro bono publico stances, and ever larger surpluses to the Treasury. But paying for these costs, when one's competitor does not, has its breaking point. For us, that point came when we had to slash our prices merely to retain a major portion of our customer base which was being wooed away but offers of interest-bearing checking accounts (i.e., NOWs). Structured as we are -- large, but primarily a community-oriented organization -- we could no longer carry the Fed on our back and meet the challenges from those with lighter burdens. The happenstance of fierce price competition for deposit business surfacing during a time of declining interest rates, recession, and heavier-than-usual loan loss provisions, made matters all the more difficult. These added factors probably would not have been persuasive in and of themselves, however.[20]

V. Implications of Federal Reserve Loss of Membership.

Many serious implications have been noted as possible results of continued Federal Reserve membership decline. It has been proposed that: the Fed's monetary control would be weakened; the nation would face high liquidity risks; the Fed would lose its predicting and target capabilities; and a substantial loss to Treasury revenues would be experienced. Others contend that few, if any, problems would accrue as a result of serious decreases in membership.

The Federal Reserve claims that the membership problem complicates the system's monetary control, and threatens the strength of the Federal Reserve as an independent government entity. According to Chairman Burns,

> As the proportion of bank deposits at member banks declines, the links between bank reserves on the one hand, and bank credit and the money supply, on the other, are loosened, this lessens the precision of the Federal Reserve's monetary control.[21]

Although, in theory, it is possible to attain monetary targets through the use of an open market operations without member banks, the Fed argues that realistically this cannot occur. Without uniformly regulated, cash/deposit ratios, the Federal

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20 December 27, 1977, Letter from William M. Crozier, Jr., Chairman of the Board and President, Bay Banks, Inc., Boston, Mass., to Honorable J. William Stanton, Ranking Minority Member, Committee on Banking, Finance, and Urban Affairs, U.S. House of Representatives.

21 Fed Hearings, p. 35.

Reserve asserts they would be unable to predict the volume of open market operations needed to achieve their objective. In addition, any fluctuation in desired ratios by individual banks could have a substantial effect on the money supply, which, under the present system, corresponds to a change in legal reserve requirements. Using an "unrealistic assumption," i.e., a virtual "guess" at the cash/deposit ratios, the Fed would have to forsee the timing and magnitude of these shifts in order to counter their effects.[22]

Control of the economy through manipulation of reserve requirements, a second tool of monetary policy, could be severely affected by the membership problems. Obviously, the fewer members, the less opportunity the Fed has to influence monetary policy through reserve requirements. In addition, the Board is somewhat restricted in raising requirements, because of its likely detrimental affect on membership. With higher requirements, more members would be subjected to a competitive disadvantage and, therefore,more members may select the non-membership alternative, further aggravating the existing problem. A related argument to the control problem concerns information. Accurate weekly data is necessary to conduct monetary policy. The Federal Reserve claims such data is received only by member banks. Although the FDIC supplies data from a sample of non-members, this apparently is insufficient to allay the Fed's fears that membership erosion, and an accompanying lack of information, will inhibit their monetary control capabilities.

Along with a loss of monetary control, the Federal Reserve is also concerned with a potential weakening of the banking system. Because non-members do not have direct access to the discount window, they must rely on their correspondents for credit needs. Dr. Burns feels "banking history demonstrates that

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22 Ibid., p. 434.

correspondent banks cannot fulfill the function of lender of last resort in periods of strong overall credit demands."[23] With banks continuing to move outside the system, "severe disruptions" may occur because the private sector is unable to be the lender of last resort.[24] Furthermore, Dr. Burns asserts that "the underlying strength of the banking system is gradually, but definitely being eroded,"[25] especially due to the nature of many of the withdrawing banks. Many of these banks have been weak and felt non-membership status would aid in lowering costs. These banks, in Dr. Burns' opinion, pose a significant liquidity risk and "can least afford to forfeit the insurance policy of ready access to the Federal Reserve counter and to the discount window."[26]

Declining membership also results in a reduction of Treasury revenues, as the Fed invests in Treasury securities in an amount equal to Federal Reserve notes used for reserve balances and any excess vault cash held by members. Table 6 (see Appendix) represents a Fed study on reduced Treasury revenues from attrition in Fed membership. According to this study, Treasury revenues would have been approximately $88 million higher in 1976 if the 1950 ratio of member/total bank deposits were maintained. If attrition declines at its present rate, annual Treasury revenue by 1982 will be $100 million below the 1976 level.[27]

Opponents of the Federal Reserve's emphasis on the importance of membership maintain that monetary control will not be lost, the Fed need not lose its predictive capabilities, and the nation's banking structure will not be weakened. In the opinion of Professor James Pierce, Professor of Economics, University of California, Berkeley:

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23 Ibid., p. 36.
24 Fed Study, p. 7.
25 Fed Hearings, p. 41.
26 Ibid., p. 36.
27 Fed Study, p. 10.

> Membership attrition does not appear to have posed a significant problem for monetary policy so far. Existing studies demonstrate the relative unimportance of membership as a factor inhibiting the effectiveness of monetary policy.[28]

These studies include one completed in 1974, which concluded that there exists no indication from available evidence that the non-member banking segment has hampered monetary policy.[29] A 1975 study supported this conclusion, and further stated that no evidence had been found illustrating a need for non-member reserve requirements to provide "precision in monetary control."[30]

Loss of monetary control through the inability to use reserve requirements as a monetary tool can be countered by the argument that, historically, reserve requirements have seldom been used; instead, open market operations have been the Fed's chief tool of operation. The Fed's contention of loss of monetary control due to lack of accurate information is viewed as a problem with a relatively easy solution. Professor Pierce states:

> Data collection is an important issue that is separate but easily confused with the membership issue. This problem can be solved by authorizing the Federal Reserve to collect timely reports on the deposits of non-member depository institutions. It is not necessary that these institutions be members of the Federal Reserve, only that they report data on their deposits.[31]

Thus, the Federal Reserve need not lose data with declining membership.

Already moving in this direction, S. 1664, which passed through the Senate Banking Committee in June 1977, and has received FDIC endorsement, would require every depository institution offering NOW Accounts to "make reports concerning its deposit liabilities and required reserves at such times and in such manner and form as the (Federal Reserve) Bank may require." Mr. George LeMaistre,

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28 Fed Hearings, p. 774.
29 Gary Gilbert and Petersen, "Uniform Reserve Requirements, Some Policy Issues," Journal of Banking Research, Spring 1974.
30 Dennis Starleaf, "Non-member banks and monetary control," Journal of Finance, September 1975.
31 Fed Hearings, p. 775.

Chairman of the FDIC, has also supported Fed authorization to obtain any and all information it needs to conduct monetary policy. In addition to the existing FDIC weekly survey of a sample of non-member banks, which was initiated with the Spring 1976 Call Report, as of July 1977, a sample of non-member banks are asked to report deposit and cash items on a regular weekly basis (all non-members report these 4 times a year). According to Mr. LeMaistre, "the Federal Reserve has indicated that the use of the data from the two projects mentioned will enable them to achieve significant improvements in their estimates for the non-member bank components of the nation's money supply."[32]

The final counter argument to the Fed's position concerns the probability of liquidity risks. Fed opponents feel that correspondent banks are stable and able to handle credit difficulties. If an extreme emergency were to arrive, however, some propose that non-members should have direct access to the discount window. According to Dr. Pierce:

> If the current machinery is too cumbersome for the Federal Reserve to be able to lend to a non-member bank in the emergency situation, then the Federal Reserve ought to be up here asking for the legislation to be changed rather than saying the only way that we can accomplish lending to non-member banks in an emergency is to make them members.[33]

Thus, opponents believe that: the Federal Reserve's fears are unfounded, and an overreaction to withdrawals from the system; declining membership will not seriously damage the banking system; and current problems could be handled through relatively simple legislation to ensure the Federal Reserve adequate controls to conduct monetary policy efficiently.

Whether or not one views the decline in Federal Reserve membership as a serious threat to the system's efficient operation, there is no question that a

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32 Ibid., pp. 116-117.
33 Ibid., p. 786.

continued decline would serve to reduce the Fed's strength. "The important thing to recognize is that the Federal Reserve is a unique institution whose basic features are worth preserving because it has, by and large, served the nation well."[34]

VI. Analysis of Proposals to Combat Membership Decline.

A number of solutions have been offered to arrest the downward trend in membership. The proposal currently receiving the most support would authorize the Federal Reserve to pay interest on its reserves. The Fed, the Treasury, and the Administration, as well as the American Bankers Association, find this solution, in some form, to be the most acceptable alternative. (The Fed however, has pushed for interest payment on reserves as being inextricably linked to their acceptance of nationwide NOW's.) Referring to discussions held between the Federal Reserve and the Treasury, Secretary Blumenthal admitted, "other options such as lowering reserve requirements or requiring reserves from non-member financial institutions were considered, but the payment of interest on required reserves appeared to be the most equitable."[35]

Paying interest on reserves would hopefully offset members' opportunity cost for idle reserves and reduce the withdrawal rate from the system, thereby eliminating what is termed a "tax on banks." As explained by Dr. William Silber, Professor of Economics and Finance, Graduate School of Business, New York University:

> (The payment of interest on reserves) is a far superior solution because at the same time that it solves the membership problem it also solves the tax problem - and creates a tax

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34 Golembe Associates, Inc., "A Perspective on the Federal Reserve Membership Problem and Its Proposed Solutions," July 29, 1977, p. 14.

35 Fed Hearings, p. 8.

> problem for the Treasury - in that regulation of required reserves at zero interest is a tax on the banks. I don't think that the Congress legislated that tax on purpose.[36]

Other advantages from the interest payment proposal include: flexibility in determining rates, etc. (S. 1664 gives the Federal Reserve discretion to concentrate its interest payments among those banks suffering the greatest competitive disadvantage, and those most likely to leave the system); only slight interference with existing institutional arrangements in the banking industry; and according to Federal Reserve Governor Coldwell, the clear implication to member banks that the system wishes to offset the costs of membership.[37]

Critics of this proposal claim that interest payment on reserves may cause state authorities to retaliate by reducing non-member reserve requirements, thereby re-enforcing the cost differential now existing between members and non-members. Another argument focuses on the budget implications from the loss of Treasury revenues due to interest payments. In response to the first criticism, a Federal Reserve study found that state authorities must reduce reserve requirements by five to ten times the amount as the Federal Reserve to offset a Federal Reserve requirement reduction, and therefore concludes:

> Since reserve reductions by states of this order of magnitude are unlikely, and, in many cases, mathematically impossible, it appears that the Federal Reserve can act without threat of state retaliation to reduce or eliminate the burden of membership by paying interest on required reserves.[38]

In terms of the cost to the Treasury, if membership continues to decline, the Treasury will lose revenue regardless; i.e., according to Secretary Blumenthal, if the current rate of attrition continues, the annual net cost to the Treasury might be between $200 - $300 million. Therefore, if the impact to the Treasury from interest payments on reserves does not exceed these estimated

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36 Ibid., p. 784.
37 Ibid., p. 18.
38 Fed Study, p. 81.

figures, the Treasury would be "neutral," and agreeable to Treasury's net losses of this level.[39] Since the Treasury would be able to recover approximately 55% of interest payments through income tax from the amount of increased revenues of recipient commercial banks,[40] a net reduction of $200 - $300 million would imply aggregate interest payment in the range of $330 million to $500 million the first five years.

Critics have approved this line of thought on the basis that interest payments on reserves, subject to some exogenously imposed variable (e.g., S. 1664 limits the amount of interest that may be paid on reserve balances to no more than 10% of the net earnings of the Federal Reserve in the preceding year), cannot be very effective in stemming the tide. Even if those banks which are "more disadvantaged" received a higher percentage of payments, ill feelings of inequitable treatment could potentially encourage dissatisfaction with the Federal Reserve System at other "less suffering" banks.

Obviously, the structure of interest payments would have to be carefully analyzed before this proposal were put into effect. Uniform rates would exacerbate the existing problems - as large banks with large reserves would receive more interest - yet it is they who employ most of the benefits of Fed membership. Therefore, some graduated system, or at least guidelines should be established if the Treasury were authorized to pay interest on reserves.

Uniform reserve requirements (i.e., mandatory Federal Reserve membership) for all depository institutions is the approach considered by the Fed to be the "best and most simple solution."[41] With this solution, the Fed claims that the costs of idle reserves would be imposed equally on all institutions, and in ad-

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39 Fed Hearings, p. 4.
40 Ibid., p. 36.
41 Phillip E. Coldwell, Member, Board of Governors of the Federal Reserve System, Testimony before the U.S. Senate Banking Committee (95th Cong., 1st Session), October 11, 1977, p. 17.

dition, monetary control would be strengthened. Congress, however, has been opposed historically to this idea (for the obvious reasons that it would significantly increase the jurisdiction of the Federal Reserve). The dangers of this approach were also highlighted by Liddon McPeters, President of the ABA:

> It would be a serious mistake to solve this problem by requiring membership in the Fed or by allowing it to extend its control to the reserves of financial institutions that have neither federal charters nor any voluntary affiliation with the Fed. That would be little more than a backdoor means of destroying the dual system of banking in this country.[42]

Universal membership could also be detrimental to existing competition in correspondent banking, as the Federal Reserve might

> ...not only retain its monopoly over the reserves it now provides, but also extends its monopoly to other services.... Inasmuch as the Federal Reserve already has a negative impact on private competition in correspondent banking, there seems little point in inviting a compounding of this problem.[43]

Also, in light of the dominantly negative reaction toward reserve requirements of the majority of bankers questioned in the 1977 Bank Survey cited previously, continuing strong negative reaction would likely be expected from non-member banks, banking groups (especially those representing small banks) and state bank supervisors.

Another suggested solution allows for decreasing reserve requirements to the point at which they could cover the cost of system services. Necessarily, this proposal would require first, an exhaustive analysis of each bank's usage of Fed services, as well as a comprehensive pricing structure. It therefore would not be a desirable first step. The pricing questions, the Federal Reserves' emphasis on the importance of adequate reserves, and the ABA's objection to differing reserve requirements for individual member institutions, seem to indicate that approach would likely receive little support.

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42 Fed Hearings, p. 162.
43 Golembe Associates, Inc., p. 42.

The pricing of system services is another proposal often set forth in connection with alleviating the Fed membership problem. Some difficulties must first be overcome. For example, in the effort to define service charges, one is faced with difficult problems such as assigning costs for services with multiple functions, allocating long run costs, etc. Governor Coldwell of the Federal Reserve has indicated pricing would only be acceptable after payment of interest on reserves was in effect (which puts some damper on the political prospects for passage of such a straightforward plan).

It would seem the most (and politically feasible) desirable solution to the membership problem would be to couple interest payment on reserves with explicit pricing of Fed services. Either proposal by itself would further aggravate the existing problem: interest payments alone will result in further inequities, as cited before; and explicit pricing for what are now free services, would increase the cost of membership beyond the present burdens. As a combined approach, however, members would be paid for reserves they kept, in exchange for charges for exactly those services they receive -- thereby providing a much more equitable cost/benefit type arrangement to Federal Reserve membership, and hopefully halt the trend toward decline. (This proposal might even be extended to make Fed services available to non-member banks, in exchange for either explicit charges or reserve balance equivalents.)

One last approach which might be recommended as a means of halting attrition from the Federal Reserve System would be an effective reduction of required reserves, i.e., allowing member banks to invest at least part of their reserve requirements in Treasury securities, rather than experiencing the presently burdensome opportunity costs of idle cash balances, which members resent. It would seem that this proposal has several advantages so that it might be appealing: (1) it does not endanger the Federal Reserve concern with an adequate level of aggregate reserves; (2) most state banking authorities already allow their banks such investment of reserves; (3) there would be no loss of revenue to the Treasury; and (4) Congressman Reuss, Chairman of the House Banking Committee, has endorsed this proposal that banks be allowed to satisfy up to 50% of their reserve requirement by purchasing Treasury bills. (Mr. Reuss has also supported the suggestions of John Bunting, Chairman of the Chief Executive Officer of First Pennsylvania Corp., and First Pennsylvania Bank, that member banks be allowed to funnel currency into a special account, not permitted to be used for dividends to shareholders, to build up bank capital positions - also an area of concern in the financial community.) Chairman Reuss also stated "if banks could earn interest on reserves, through one plan or another they would probably use the earnings to bolster their capital positions." Congressman Reuss also suggested considering the proposal to exempt the first $15 to $50 million of a member bank's deposits from reserve requirements.[44]

VII. Recommendations.

It has been illustrated that a substantial amount of evidence is available which indicates a withdrawal of member banks from the Federal Reserve System. A major cause of the membership decline appears to be the cost of holding idle reserves with the Fed. The New England withdrawal rate, in conjunction with survey results suggesting bankers believe they may achieve higher earnings as non-members support this conclusion. If in fact membership decline is deemed to be a problem, it seems that the three-pronged approach of interest payment on Fed reserves, coupled with Fed pricing of system services, and a reduction in effective reserve requirements (via investment in Treasury securities or other alternatives), would be the recommended course to follow, and that which might prove politically acceptable to many of the parties concerned.

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44 ______________, "Reuss Lauds Bunting's Capital Account Plan," American Banker, February 14, 1977.

APPENDIX

Table 1

Type of deposit, and deposit interval in millions of dollars	Requirements in effect Sept. 30, 1977		Previous requirements	
	Per cent	Effective date	Per cent	Effective date
Net demand:[2]				
0–2	7	12/30/76	7½	2/13/75
2–10	9½	12/30/76	10	2/13/75
10–100	11¾	12/30/76	12	2/13/75
100–400	12¾	12/30/76	13	2/13/75
Over 400	16¼	12/30/76	16½	2/13/75
Time:[2,3]				
Savings	3	3/16/67	3½	3/2/67
Other time:				
0–5, maturing in—				
30–179 days	3	3/16/67	3½	3/2/67
180 days to 4 years	[4] 2½	1/8/76	3	3/16/67
4 years or more	[4] 1	10/30/75	3	3/16/67
Over 5, maturing in—				
30–179 days	6	12/12/74	5	10/1/70
180 days to 4 years	[4] 2½	1/8/76	3	12/12/74
4 years or more	[4] 1	10/30/75	3	12/12/74

	Legal limits, Sept. 30, 1977	
	Minimum	Maximum
Net demand:		
Reserve city banks	10	22
Other banks	7	14
Time	3	10

[1] For changes in reserve requirements beginning 1963, see Board's *Annual Statistical Digest, 1971–1975* and for prior changes, see Board's *Annual Report* for 1976, Table 13.

[2] (a) Requirement schedules are graduated, and each deposit interval applies to that part of the deposits of each bank. Demand deposits subject to reserve requirements are gross demand deposits minus cash items in process of collection and demand balances due from domestic banks.

(b) The Federal Reserve Act specifies different ranges of requirements for reserve city banks and for other banks. Reserve cities are designated under a criterion adopted effective Nov. 9, 1972, by which a bank having net demand deposits of more than $400 million is considered to have the character of business of a reserve city bank. The presence of the head office of such a bank constitutes designation of that place as a reserve city. Cities in which there are F.R. Banks or branches are also reserve cities. Any banks having net demand deposits of $400 million or less are considered to have the character of business of banks outside of reserve cities and are permitted to maintain reserves at ratios set for banks not in reserve cities. For details, see the Board's Regulation D.

(c) Member banks are required under the Board's Regulation M to maintain reserves against foreign branch deposits computed on the basis of net balances due from domestic offices to their foreign branches and against foreign branch loans to U.S. residents. Loans aggregating $100,000 or less to any U.S. resident are excluded from computations, as are total loans of a bank to U.S. residents if not exceeding $1 million. Regulation D imposes a similar reserve requirement on borrowings from foreign banks by domestic offices of a member bank. A reserve of 4 per cent is required for each of these classifications.

[3] Negotiable orders of withdrawal (NOW) accounts and time deposits such as Christmas and vacation club accounts are subject to the same requirements as savings deposits.

[4] The average of reserves on savings and other time deposits must be at least 3 per cent, the minimum specified by law.

NOTE.—Required reserves must be held in the form of deposits with F.R. Banks or vault cash.

Table 2

CHANGING MEMBERSHIP IN THE FEDERAL RESERVE SYSTEM

Year[1/]	Per Cent of Banks Which are Members	Percentage Point Change Over: Previous 5 Years	Percentage Point Change Over: Previous Year	Per Cent of Gross Deposits Held by Members	Percentage Point Change Over: Previous 5 Years	Percentage Point Change Over: Previous Year
1950	48.7			85.7		
1955	47.7	-1.0		85.2	- .5	
1960	45.8	-1.9		84.0	-1.2	
1965	45.1	-0.7		82.9	-1.1	
1970	42.1	-3.0		80.0	-2.9	
1975	39.5	-2.6		75.1	-4.9	
1971	41.6		-0.5	79.1		-.9
1972	41.0		-0.6	78.3		-.8
1973	40.5		-0.5	77.3		-1.0
1974	40.0		-0.5	77.0		-.3
1975	39.5		-0.5	75.1		-1.9
1976	39.3		-0.3	73.8		-1.3

1/ As of end of year.
NOTE: Figures are ratios of member to all commercial bank data.

Fed Study: "The Burden of Federal Reserve Membership, NOW Accounts, and the Payment of Interest on Reserves."

Table 3

VOLUNTARY SHIFTS IN MEMBERSHIP BY SIZE OF BANK
1970 -1976

Size (Total Deposits in Millions of Dollars)	Members Becoming Nonmembers								Total
	1970	1971	1972	1973	1974	1975	1976	1977 (5 mo.)	
Less than 10	49	22	22	18	8	18	11	11	159
10-50	26	16	28	20	27	19	25	17	178
50-100	2	3	3	5	3	4	5	1	26
100-500	0	0	5	6	10	1	5	13	40
Total	77	41	58	49	48	42	46	42	403

Fed Study: "The Burden of Federal Reserve Membership, NOW Accounts, and the Payment of Interest on Reserves."

Table 4

EARNINGS AND MEMBERSHIP BY SIZE OF BANK

	Bank Size (Total deposits $ millions)					
	Less than 10	10-50	50-100	100-500	500-1000	Over 1000
1. Earnings disadvantage of member banks, 1970-76 (in per cent)1/	8.2	6.1	4.7	2.4	-1.0	n.a.2/
2. Percentage of member banks withdrawing from System since 1970	13.5	5.6	3.8	7.4	0	0
3. Percentage of banks belonging to the System as of end of 1976	24.1	43.2	59.3	69.4	86.3	89.8
MEMO: Number of member banks, end of 1976	1180	3188	678	542	82	88

1/ Calculated by comparing ratio of before tax income to total domestic and foreign assets of member banks and nonmembers and averaging percentage differences in ratios over 1970-76.

2/ Not applicable. All comparisons are for 1970-76, and before 1976 there were three or fewer nonmembers with deposits over $1 billion. In 1976 there were ten nonmember banks with deposits over $1 billion at year-end. The ratio of large member bank before tax earnings to assets exceeded that of the few nonmembers by about 8 per cent in 1976.

1/ The only exception is the $100-500 million size category where the rate of withdrawals increases despite a smaller earnings disadvantage. This probably reflects the greater sensitivity to earnings differentials of these banks.

Fed Study: "The Burden of Federal Reserve Membership, NOW Accounts, and the Payment of Interest on Reserves."

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Table 5

PERCENT OF COMMERCIAL BANKS THAT ARE
MEMBERS OF THE FEDERAL RESERVE SYSTEM

	United States	1st district	Massachusetts and New Hampshire
As of yearend—			
1971	42.1	59.7	63.4
1972	41.6	56.7	61.8
1973	41.1	54.4	60.4
1974	40.7	53.0	59.4
1975	40.3	52.9	59.0
1976	40.0	51.5	58.6
May 1977 [1]	39.8	49.0	54.8

[1] Partially estimated.

Fed Hearings, "Hearings on NOW Accounts, Federal Reserve Membership and Related Issues."

Table 6

ILLUSTRATION OF REDUCED TREASURY REVENUES FROM ATTRITION IN FED MEMBERSHIP

Year	(1) Commercial Bank Total Deposits	(2) Actual Member Bank Deposits	(3) Member Bank Deposits if 1950 Proportion Maintained	(4) Difference (3)-(2)	(5) Amount by Which Fed Security Holdings are Lower 1/	(6) Amount by Which Fed Earnings are Lower 2/	(7) Amount by Which Treasury Revenues are Lower 3/
	($ billion)	($ billion)	($ billion)	($ billion)	($ million)	($ million)	($ million)
1950	155.3	133.1	133.1	--	--	--	--
1955	192.3	163.7	164.8	1.1	107	1.3	.6
1960	229.8	193.0	196.9	3.9	288	8.9	4.0
1965	332.4	275.5	284.9	9.4	537	15.8	7.1
1970	481.7	385.2	412.8	27.6	1,474	71.7	32.3
1975	786.5	591.0	674.0	83.0	3,486	179.6	80.8
1976	838.3	618.9	718.4	99.5	3,890	195.5	88.0

1/ Column (4) times average reserve requirement against all deposits for member banks with deposits less than $100 million in each year less average nonmember bank holdings of vault cash. Latter amount is subtracted from average reserve requirements because even if a member bank were to withdraw from the System, it would have to maintain vault cash equal to that of an average nonmember. Since the Fed holds securities against Federal Reserve notes, System earnings would only be reduced by the amount of reserve balances withdrawn plus excess cash held by members over and above that of nonmembers.

2/ Column (5) times three-fourths of average rate of return on System portfolio in each year. The three-fourths factor is an adjustment for lower System expenses due to the shrinkage in membership.

3/ Column (6) times .45. Latter figure assumes the average marginal tax rate against banks is 35 per cent and an additional 20 per cent in tax revenue is collected from dividends and capital gains. Thus, of each dollar reduction in the System payment, an estimated 55 cents is returned to the Treasury through higher taxes and 45 cents is lost.

Fed Study: "The Burden of Federal Reserve Membership, NOW Accounts, and the Payment of Interest on Reserves."

Mr. STANTON. I promised to yield to my colleague from Ohio, Mr. Wylie.

Mr. WYLIE. Thank you, Mr. Chairman and Mr. Stanton.

Mr. Chairman, Robert G. Stevens, who is the chairman, president, and chief executive officer of the BancOhio Corp., was scheduled to be here to present testimony this morning. As you know from letters he has written to us, he does have a vital interest in this legislation now before us. He encountered a conflict in his scheduling and found it necessary to remain in Columbus but has presented a statement with John G. McCoy, president and chief executive officer, First Banc Group of Ohio, Inc., and Arthur D. Herrmann, president and chief executive officer of the Huntington Bancshares, Inc., and I ask unanimous consent that their statement be made a part of the record at this point.

The CHAIRMAN. Is there objection? Without objection, that statement will be made a part of the record at this point.

[The statement referred to follows:]

September 21, 1978

Honorable Chalmers P. Wylie
United States Representative
House Office Building
Washington, D. C. 20515

Dear Congressman Wylie:

Your efforts to gather facts and evaluate the impact of proposed legislation relative to reserve requirements (H.R. 14072) is to be commended. While we are unable to appear at the hearing scheduled for Friday, September 22, 1978, we have, as representatives of the three bank holding companies headquartered in your congressional district, prepared the following statement for the record.

We, the undersigned, represent the bank holding companies described below:

	BancOhio Corporation ($000's)	First Banc Group ($000's)	Huntington Bancshares ($000's)
Total Deposits June 30, 1978	3,382,708	1,725,339	1,677,498
Number of Banks in Company	41	16	15
Number of Member Banks	35	14	11
Total Investment in Federal Reserve Stock	5,499	2,680	2,048
Total Reserves at June 30, 1978	165,795	102,009	89,581
Estimated Reserves required at June 30, 1978 under provisions of proposed legislation (H.R. 14072)	75,285	37,274	48,180
Estimated vault cash required in banks exempt from reserves	29,530	13,961	8,569
Percentage decrease in reserves adjusted for vault cash under proposed legislation	37%	50%	37%

As can be seen in this schedule, most of the banks in our systems are members of the Federal Reserve. The proposed legislation would reduce the total amount of reserves required for the banks in each of our holding companies. The net cost or benefit of the proposed legislation cannot be determined until the proposed system for pricing Federal Reserve services is defined.

We recommend that legislation regarding reserves be deferred pending a study to evaluate the present system of reserves and the required investment in Federal Reserve stock as it impacts such factors as public confidence, monetary policy, availability of credit, safety of depositors, as well as the effect on the relative profitability and the availability of funds among banks, savings and loans, savings banks, credit unions, and non-depository financial institutions.

Changes in reserve rules cause significant shifts in relative profitability among the various classes of financial institutions. Under the proposed rules for example, larger, state non-member banks become less profitable because most state banks are allowed to invest reserves in government securities as contrasted to non-earning deposits at the Federal Reserve. Under the proposed rules, savings and loans, savings banks, and credit unions will still maintain this advantage. We believe that Congress should have sound and logical reasons for changing the relative position of some financial institutions, but not changing the position of others.

Within each class of institution, there are shifts in relative profitability as a function of size -- smaller banks are exempt from reserves while larger banks are not. If two banks merge, and are better able to meet the credit needs of their communities, the increase in size could take the combined bank beyond the exemption level. The characteristics of their customers should not have changed so as to create a need for greater reserves. These rules, therefore, constitute a penalty for growth. Congress should determine whether such rules will foster economic behavior which supports community growth and employment.

These new rules also cause a shift in profitability among banks as a function of the mix of deposits -- banks with a greater proportion of demand deposits benefit more than banks with a greater proportion of savings deposits. Longer term deposits will, so far as reserves are concerned, be relatively more profitable than the traditional passbook savings account. It is likely that these rules will foster the development and promotion of longer term savings instruments. It is more difficult to forecast the desirability of this change in emphasis.

As a rule, home mortgage lending tends to follow an emphasis on savings. It is unusual to see Congress making the savings function less attractive than it has been in the past.

We also offer the following points for further consideration:

1. The reserve rules proposed in H.R. 14072 appear to be too specific to be responsive to changes in the economy. We would suggest that legislation should define policy but give the Federal Reserve greater latitude in the exercise of that policy.

2. H.R. 14072 does not recognize the significant financial burden that is involved in the required ownership of Federal Reserve stock. Additional stock must be purchased each time capital is increased. The 6% yield on the stock is below that of alternative investment opportunities. It represents a penalty for providing greater capital protection to depositors.

3. Under the proposed reserve rules, the reserve rate on savings deposits would increase from 3% to 7%. It is our opinion that this reduces funds available for home mortgages by 4%. We question whether this is consistent with the intent of other legislation and commonly accepted social objectives.

While savings accounts can soon be linked to transactional accounts, studies and results experienced to date indicate that something less than one fourth of all savings accounts in commercial banks will be involved. Therefore, the increase in reserves for all savings accounts does not appear to be justified, and either no increase should be instituted or a differentiation between transactional savings and traditional savings should be made.

4. The exemption of any bank from reserve requirements does not appear to be consistent with long standing concepts of safety and soundness, nor is the exemption of smaller banks consistent with the pattern of bank failures in American banking history. Further, the idea of non-earning reserves is a definite impediment to achieving an adequate return on deposits which is the most essential element in promoting the safety and soundness of the banking system.

The inter-relationships between profitability and other factors such as availability of funds, interest rate controls (Regulation Q), availability of credit, depositor safety, and monetary policy are very complex. Awarding advantages or achieving equality among different classes of financial institutions is an equally complex set of issues. At the same time, the results of these interactions are very important to the citizens of our nation in very direct and tangible ways.

We do not feel that the membership problem of the Federal Reserve is at such a crisis state as to require experimentation with new reserve rules without a careful analysis of the possible consequences of these changes, not only on financial institutions, but upon every depositor and borrower who is served by these institutions.

Respectfully submitted,

Robert G. Stevens
Chairman, President and
Chief Executive Officer
BancOhio Corporation

John G. McCoy, President
and Chief Executive Officer
First Banc Group of Ohio Inc.

Arthur D. Herrmann, President
and Chief Executive Officer
Huntington Bancshares Inc.

Mr. WYLIE. Thank you.

The CHAIRMAN. I would like to recognize the distinguished chairman of the Subcommittee on Financial Institutions Supervision, Regulation, and Insurance. By reason of his jurisdiction and expertise, an outstandingly valuable member of this committee, the gentleman from Rhode Island, Mr. St Germain.

Mr. ST GERMAIN. Thank you. You might tell Bob Stevens it is unfortunate he couldn't make it. He is a graduate of the Rhode Island banking fraternity. He learned a lot there.

Mr. Chairman, I appreciate the opportunity to introduce Theodore W. Barnes, president of the Old Stone Bank in Providence, R.I. Mr. Barnes represents one of the Nation's oldest financial institutions. The bank can indeed lay claim to being owned and controlled by local people and its own depositors.

While I generally favor this legislation, and while I am anxious to give the Fed the necessary monetary base to control inflation, I have great concern about some of the apparent hardships created by the bill.

Old Stone, because of its unique nature as a locally owned institution which prides itself in maintaining a maximum number of small savings accounts, is hit particularly hard. Old Stone has more than 91 percent of its deposits in savings and time accounts. This bears great similarity to thrift institutions that are exempt under this bill.

Under this legislation, Old Stone will have to tie up some $37 million in reserves and not surprisingly this does have an adverse impact on both the bank's earnings and its ability to lend to local citizens.

You know, the Old Stone Bank a few years ago adopted an advertising campaign where they used the "Flintstones" we are familiar with. The concern here is that they have been breaking profits down into pebbles and distributing it to about 57,000 depositors who are stockholders in the State of Rhode Island—these profits—and they are concerned that the pebbles will end up being pea stones, and that is why we want to take a very, very careful look at the situation.

Therefore, I hope my colleagues will listen closely this morning to Mr. Barnes, because I am interested in seeing what can be done in situations such as this while maintaining the basic thrust of the legislation and assuring the Nation that we do have available all the necessary tools to hold down inflation.

I thank the chairman for allowing me this opportunity to introduce Mr. Barnes with a slight insight that he will expand upon the impact on the Old Stone Bank and its depositor shareholders in the State of Rhode Island.

The CHAIRMAN. A most worthy introduction, Mr. Barnes. We are both fortunate to have an association with Mr. St Germain, and we would like you to be our first witness, if you will.

STATEMENT OF THEODORE W. BARNES, PRESIDENT, OLD STONE BANK, PROVIDENCE, R.I.

Mr. BARNES. Mr. Chairman, and members of this distinguished committee, I would like to thank you for the opportunity to comment on H.R. 14072. As Mr. St Germain said, I am Theodore W. Barnes, president of Old Stone Bank. We are a $1.2 billion State charter nonmember bank headquartered in Providence, R.I.

I appear today in opposition to the major proposals embodied in the bill. This bill, while attempting to deal with the issue of declining Fed membership, raises fundamental concerns about its implications for the Nation's banking structure.

Specifically, I am concerned that the viability of the dual banking system may be permanently damaged. There could be a shift of power away from the State regulatory agencies if the large nonmember banks choose national charters. There would be a massive reallocation of income as the smaller banks are no longer required to hold sterile reserves, and many of the largest member banks have reductions in these requirements while nonmember banks are forced to pay for membership whether or not they utilize the services.

The competitive balance in many States would be disruptive since the bill does not provide for equitable treatment of all types of depository institutions. Such a massive reallocation of the profits of our Nation's banks and the implications for the evolution of the banking system deserves more study than has been done to date.

I would like to focus on the concern of the impact of this bill on the competitive balance in Rhode Island and its impact on the viability of the dual banking system. Rhode Island has a unique banking structure. This has been acknowledged by the Federal Reserve on many occasions. The State banking laws in Rhode Island have permitted the development of a distinctive structure of financial institutions. Every mutual savings bank in our State owns and operates a full-service commercial bank and offers commercial loans and demand deposits as well as all the services of the thrift institutions in common facilities.

The same is true for savings and loan associations where 87 percent of the deposits in these institutions also operate in a dual capacity. This is the only State in the Nation where savings and loans and commercial banks are permitted to operate together.

Old Stone was a mutual savings bank for 155 years, as the Congressman said, until 1974, when we converted to a commercial bank. We issued stock to our savings depositers at that time, 1 share for every $300 they had in a savings account and today over 52,000 Rhode Island stockholders with average holdings of about 30 shares each own our bank. These stockholders, mostly working-class Rhode Islanders, would be the losers from this legislation as part of our earnings are taxed away from us and redistributed out of State to the large money center banks.

Although we are now a "commercial bank," we have maintained much of our savings bank nature with 91 percent of our deposits in savings and time deposits. The thrift-commercial bank pairs also have a similar percentage of their deposits in savings and time. However, the thrift-commercial bank pairs, which maintain their savings deposits in the thrift affiliate as compared to Old Stone's, would not be subject to reserve requirements under the proposed bill. Under Rhode Island law, the legal investments for savings deposits are the same, whether the institution is a mutual savings bank or a commercial bank. So, in fact, Old Stone today is still the largest residential mortgage lender in the State. We make approximately one out of every five mortgage loans in Rhode Island. We estimate that the proposed reserve requirement would cost Old Stone over $1.2 million or about 20 percent of our current after-tax earnings when fully implemented. Such a large reduction in earnings would require fundamental changes in Old Stone's lending operations. It would seriously affect our ability to continue to support the local residential mortgage market. It would undoubtedly raise our prices to the consumer and force us to consider a national bank charter which would allow us to invest our consumer time deposits in commercial loans.

Mr. Chairman, I believe this bill deserves further study. It weakens the dual banking system which has greatly benefited this Nation over the years. It seriously impacts many banks which typically lend strength to the State regulator system and those which give the dual system its vitality. The bill is also anticompetitive since it discriminates against banks such as ourselves whose deposits and loans have the characteristics of a large savings bank. The goal of easing the burdens of present Federal Reserve members can be accomplished much more simply through reductions in member banks' reserves to levels comparable to those prevailing in the State, and the goal of improving our monetary policy could be accomplished through a universal reporting system through all banks. Thank you for the opportunity to address this committee.

[Mr. Barnes' prepared statement follows:]

STATEMENT BY

THEODORE W. BARNES

PRESIDENT, OLD STONE BANK

PROVIDENCE, RHODE ISLAND

BEFORE THE

COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS

U. S. HOUSE OF REPRESENTATIVES

SEPTEMBER 22, 1978

Mr. Chairman, members of this distinguished committee, I would like to thank you for the opportunity to comment on House Bill 14072 - "Federal Reserve Act Amendments of 1978." I am Theodore Barnes, President of Old Stone Bank, a state-chartered non-member bank, headquartered in Providence, Rhode Island. I hope that my appearance today will contribute to the development of a coherent policy to deal equitably with the nation's commercial banks on the required reserves issue.

The Federal Reserve has, for many years, sought solutions to the problem of banks leaving the System. The proposed bill, however, could have far more significant implications for the entire banking structure:

- The viability of the dual banking system may be permanently damaged. There could be a marked shift of power away from state regulatory agencies if the large non-member banks choose national charters.
- There would be massive reallocation of income, as the smaller banks are no longer required to hold sterile reserves and many of the largest member banks have reductions in these requirements, while non-member banks are forced to pay for membership whether or not they utilize the services.
- The competitive balance in many states would be disrupted since the bill does not provide for equitable treatment of all types of depository institutions.

Such a massive reallocation of the profits of our nation's banks and the implications for the evolution of the banking system deserves much more study than has been done to date. This distinguished committee has recognized this need in the proposed bill which mandates "a study of the likely long-run effects" of reserve requirements on savings deposits and "upon operations of financial institutions and upon the competitive structure of financial markets." I would contend that these matters are of enough significance to require analysis before action, to recognize the impact before enacting legislation to totally change our banking system. I would like to speak, specifically this morning, to this last point — the fact that there has been no consideration or study of the competitive equilibrium in many states with unusual financial structures.

Rhode Island Banking Environment

In the United States because of the dual banking system there are many unique banking regulatory structures that have allowed each state to best serve its particular needs. Rhode Island is one example of a long-established unique situation where the generic definitions of competing institutions do not apply. This has been acknowledged by the Federal Reserve on many occasions.

State banking laws in Rhode Island have permitted the development of a distinctive structure of financial institutions. Every mutual savings bank in the state owns and operates a full-service commercial bank and offers commercial loans and demand deposits as well as all the services of a thrift institution in common facilities. The same is true for savings and loan associations, where 87 percent of their deposits are in institutions that operate similarly in a dual capacity.

Old Stone was founded in 1819 as a mutual savings bank and, until 1974, continued to operate as such. It had a small commercial bank affiliate which was chartered in 1929 but only became active as a full service commercial bank in 1965. In 1974, Old Stone Savings Bank converted to a stockholder-owned bank holding company structure. In the conversion process, shares of stock were issued to approximately 110,000 savings account customers. Today, the Old Stone Corporation's stock continues to be held by small stockholders, 90% of whom live in Rhode Island. There are presently over 52,000 Rhode Island shareowners of Old Stone, about one in every six households in the state. These small shareowners, averaging only 30 shares each and representing mainly working class Rhode Islanders, would be severely injured by the financial impact of H. R. 14072.

Although we are now a "commercial bank," we have maintained much of our savings bank nature with 91 percent of deposits in savings and time deposits. The thrift-commercial bank pairs also have a vast majority of their deposits in savings and time. However, unlike those institutions, Old Stone's deposits would be subject to reserve requirements under the proposed bill. Under Rhode Island law, the legal investments for savings deposits are the same whether an institution is a mutual savings bank or a commercial bank. In fact, Old Stone is still the largest residential mortgage lender in the state, making one out of every five mortgage loans. The cost then of maintaining these reserves is a financial burden that would make Old Stone unable to compete with these combined thrift institution-commercial banks.

We estimate that the proposed reserve requirements would cost Old Stone between $1.2 and $1.6 million or about 20 percent of after-tax earnings when fully implemented. Such a large reduction in earnings would require fundamental changes in bank operations such as reorientation of our product lines, price increases, and significant asset restructuring.

Old Stone would be forced to examine alternative methods of increasing its yield on loans — the most obvious being a national charter which would allow us to invest all of our consumer time deposits in commercial loans.

SUMMARY AND RECOMMENDATIONS

1. A disturbing aspect of these proposals is the way in which they are being presented without study of their impact. There has been no serious independent study challenging or confirming Federal Reserve statements concerning its membership needs. There has been no study of the long-range implications of the reform proposals on the differ-

ent size banks, on the Federal regulatory structure and on the Federal/ State regulatory balance, on the equilibrium of the individual state banking structures, or on the implications of the reserve reallocation for monetary policy.

2. The proposed legislation will result in a major redistribution of bank profits — primarily from larger, nonmember banks to the largest and smallest present Federal Reserve members.

3. The Bill will result in an unfair competitive burden being placed on larger banks with required reserves versus small banks without such reserves, and on those larger nonmember institutions which will gain little or nothing in terms of benefits from the Federal Reserve but will be required to bear the required reserve burden.

4. The goals of easing the burdens of present Fed members can be accomplished much more simply through reductions in Fed reserves to levels comparable to those prevailing in the states, and the goal of improving monetary policy could be accomplished through a universal reporting system for all banks.

5. The new system will have profound effects on the development of the nation's bank regulatory structure, including the importance of the states as chartering and supervisory agencies, and the relative importance of the FDIC, the Comptroller of the Currency, and the Federal Reserve in bank supervision. Numerous banks will have new incentives to change their regulatory status.

6. The evolution of the nation's banking structure will be importantly affected by any plan that confers a new, more advantageous position on smaller banks, and continues to discriminate in favor of all thrift institutions.

7. Although it is widely argued in the political arena that the erosion of membership in the Federal Reserve System impedes the efficient operation of monetary policy, this assertion is flatly contradicted by serious scholarly work on the subject. Moreover, there is little or no reason to believe that additional study will bear out the Federal Reserve's claim. Apparently the only reason that there has been any acceptance of the proposition that the membership "problem" interferes with monetary policy is simply because that assertion has been repeated endlessly by the Fed, but without substantiating evidence.

In summary, the far-reaching implications of the proposed Bill for our nation's banking system, the entire regulatory framework, and invidual banking markets demand serious consideration before legislation action.

Appendix A

Federal Reserve Comments on Rhode Island

A Federal Reserve Bank of Boston research report on changing commercial bank structure in New England captures the nature of Rhode Island's financial industry very well. A portion of that report follows:

> Liberal state banking laws have permitted Rhode Island depository institutions to develop distinctive characteristics. Each of Rhode Island's mutual savings banks owns a commercial bank as do three other thrift institutions. Credit unions are authorized to accept demand deposits. There are no restrictions on branching within the state;
>
> The development of bank holding companies in Rhode Island has had a different impetus than in the rest of the nation. In states with restrictive branching laws some of the stimulus for holding company formations has been a desire to create statewide organizations, which is possible only through the device of a multi-bank holding company. In Rhode Island, multi-bank organizations are unnecessary for purposes of geographic expansion

and infeasible because of the small number of banks. In fact, each of Rhode Island's 13 bank holding companies owns only one commercial bank. For several holding companies, particularly Industrial National Corporation, the motivation for holding company formation appears to have been the desire to expand beyond Rhode Island in nonbanking activities. But the majority of the holding companies in Rhode Island result from the unique Rhode Island arrangement whereby thrift institutions own commercial bank subsidiaries;

The Rhode Island arrangement, in which commercial banks are owned by thrift institutions, received special treatment when Congress amended the Bank Holding Company Act to bring one-bank holding companies under regulation in 1970. Section 2(a) (5) (f) of the Act exempts an FDIC insured mutual savings bank, which owned a commercial bank in the same state prior to 1970 under specific authorization of the state law and which has no other subsidiaries, from regulation under the Act. Two Rhode Island mutual savings banks qualified under the exemption: Centreville Savings Bank and The Savings Bank of Newport continue to own directly a single commercial bank subsidiary. Each of the other five mutual savings banks had established a formal holding company intermediary between itself and its commercial bank subsidiary by the end of 1970 and thus was subject to regulation.

The loan and investment company, Greater Providence Deposit Corporation, was exempted from Federal regulation as a bank holding company by a ruling of the Federal Reserve Board, which is responsible for interpreting and applying the Bank Holding Company Act. The ruling declared that Greater Providence Trust Company did not make commercial loans and therefore was not a "bank" as defined in Section 2(c) of the amended act.

In the 1970 session of the Rhode Island legislature, building and loan associations were authorized to own a commercial bank and Old Colony Cooperative Bank began to purchase shares of Newport National Bank in 1971. In March 1972 Old Colony Cooperative Bank received approval from the Federal Reserve Board to retain the commercial bank stock and continue to operate as a thrift institution. Old Colony Cooperative Bank is the only thrift institution in Rhode Island to enter commercial banking by establishing a new relationship with an existing commercial bank. Newport Savings and Loan Association also acted under the 1970 Rhode Island amendment by chartering a commercial bank, Island Trust Company, Newport, which opened in 1972. In both cases, the thrift institution itself is a registered bank holding company...

The links between commercial banks and thrift institutions are much closer in Rhode Island than anywhere else in the United States. At the end of 1974, nine of Rhode Island's 16 commercial banks were subsidiaries of thrift institutions. In each of these affiliations, the thrift institution owns or controls more than 90 percent of the stock of the commercial bank and the two institutions share common officers, personnel and offices. The same teller can accept a demand deposit for the commercial bank and a savings deposit for the thrift institution in each pair. Most pairs advertise jointly using a single name, and are regarded as a single institution by the public.

In view of the unified operations of the thrift/commercial bank pairs, it is necessary to consider the combined organization in assessing competition for deposits. An affiliated commercial bank has a definite advantage over an unaffiliated commercial bank of the same deposit size because all of its operating expenses are shared with its thrift parent.[1]

Although the extract quoted above was from a 1974 report, the unique competitive situation in Rhode Island has remained unchanged according to a 1976 update of the original research report.

The state's six mutual savings banks, the largest savings and loan associations and two other thrift institutions each own a commercial bank, making commercial banking organizations in Rhode Island a unique hybrid of commercial banks and thrifts.

The result of the bank expansion during the sixties and early seventies is a banking structure unique to Rhode Island, in which nine of the state's 16 commercial banks are subsidiaries of thrift institutions. Each of Rhode Island's six mutual savings banks owns a commercial bank, as do two savings and loan associations and one loan and investment company.[2]

[1] Changing Commercial Bank Structure in New England, Deborah Issacs, Federal Reserve Bank of Boston Report 59 (June, 1975), p. 129-132.

[2] Changing Commercial Bank Structure in New England, 1975-1976, Katherine Gibson, Federal Reserve Bank of Boston Report 64 (1978), p. 208-210.

In other matters of commercial bank/thrift institution joint operation, the Federal Reserve Board has noted the uniqueness of the Rhode Island market. In its ruling on D. H. Baldwin Company, 42 F. T. 11877, the Board stated:

> The Board has permitted affiliations between banks and thrifts in one narrow circumstance. Specifically, it has allowed mutual thrift institutions in Rhode Island to hold interests in commercial banks. See Newport Savings and Loan Association, 58 Federal Reserve Bulletin 313 (1972), and Old Colony Co-operative Bank, 58 Federal Reserve Bulletin 417 (1972). These decisions were based upon the unique, historical situation in Rhode Island, however, where there was a pervasive pattern of ownership of banks by mutual thrift institutions, such that a thrift lacking such an affiliation was at a distinct competitive disadvantage. See also Profile Bankshares, Inc., 61 Federal Reserve Bulletin 901 (1975).[3]

[3]Federal Reserve Bulletin (March, 1977), p. 284.

The CHAIRMAN. Thank you, Mr. Barnes. I understand, if I am correct, that you have to depart shortly for across the Atlantic. I just want to thank you for your testimony. You have educated me.

I would say this—just listening to you—that something needs to be done by the various legislatures, Rhode Island and this one, about institutions like the Old Stone Bank. Whether that something is to permit you to have a subsidiary which would do that enormous amount of home lending that you do, which is to your credit, and which subsidiary, being in the nature of a savings and loan, would not be subject to that act——

Mr. BARNES. Correct.

The CHAIRMAN [continuing]. Whether that approach would be helpful, I don't know. But I commend you on your understanding testimony. You recognize that we have a problem, too. We have to try to do something about inflation and the international dollar, and that is why we are here. We are very grateful to you.

Mr. BARNES. Thank you.

The CHAIRMAN. Because Mr. Barnes has to go, the Chair will depart from the usual rule that we hear all members of the panel before questioning. Are there any questions that anyone might have of Mr. Barnes?

Mr. St Germain?

Mr. ST GERMAIN. Thank you, Mr. Chairman. I would like to make the observation in conjunction with what the chairman just stated. Unless I am mistaken, Mr. Barnes, the reason for the conversion, and it is looked upon as one of the cleanest and close conversions ever because the stock all went to the depositors, the reason for the conversion was to enable Old Stone to better serve the Rhode Island community by increasing their deposits in the commercials and thereby allowing them to make larger loans to the business community. Is that not correct?

Mr. BARNES. That is exactly right.

Mr. ST GERMAIN. And so the solution of subsidiary S. & L. would again fly in the face of the original intent, to serve the business community. So you are on the horns of a dilemma.

Mr. BARNES. It would reduce the total amount of capital allocated for commercial loans and, therefore, the amount of loan you could make in the State. We are now the third major force in the State as an alternative for commercial and industrial loans, as well as the major lender in home mortgage lending.

Mr. ST GERMAIN. And my last point is that perhaps what we should do is look at institutions such as yours that, though they are commercials, are operating or functioning much in the same manner as thrift institutions and determine whether or not in this instance the reserve requirements on time with the savings account might not be lower to accommodate the dilemma.

I am going to work with staff on this. I think that might be a possible solution. I am afraid it will end up costing in any event, but perhaps we can avoid getting to the pea stone stage and stay at the pebble stage.

Mr. BARNES. There is a major difference between correspondent banks and banks which have large amounts of their funds in demand deposits and those of us who have most of our funds in time and savings deposits and function, in fact, exactly the way a thrift institution does function.

Certainly then the equity that the committee was striving for falls apart in some manner should you start to look at an organization like ours.

Mr. St Germain. We might look at an amendment I proposed in the legislation that resulted from the hearings 2 years ago that, unfortunately, was not espoused by the banking community, but, you know, in constant hassling over the differential, I had proposed if any commercial bank is lending 60 percent of its assets in the home mortgage market that they get the benefit of the differential, and it could be we could state if a bank in lending a tremendous amount into the residential home mortgage market, they might get some kind of exemption.

Mr. Barnes. We would be happy to see the end of the differential, Congressman.

The Chairman. Mr. Wylie?

Mr. Wylie. Thank you, Mr. Chairman. Is it your position, then, Mr. Barnes, that if we lump savings and demand deposits, we might, in fact, reduce the amount of money available from banks for home mortgages?

Mr. Barnes. I don't think there is any doubt of it. The fact is that banks, and I am sure nobody in this room is any different than we are, have to try to match maturities and the type of funds we have, both by maturity and by the rate of interest we pay. We are able to invest in mortgage loans to the extent that we have fixed rate deposits, and that we have some assurance that those deposits are going to stay with us.

We have, on the other hand, to match those deposits that are more volatile, such as demand deposits and short-term deposits, with loans that are short term and that have changing interest rates or floating rates. So, to the extent you impact on banks with large time and savings deposits, there is no question you are going to force them into a different mode, even though they don't wish to, and you will impact on the housing market for banks with that kind of mix.

Mr. Wylie. So this provision in our bill which has been reported out would be counterproductive as far as our national goal of a house for everyone?

Mr. Barnes. I think that is exactly right, and the position that the committee has recognized many times, including the chairman, when he introduced this whole subject in July, pointed out that they did not cover time and savings deposits, and thrift deposit institutions because of that difference.

Mr. Wylie. Thank you very much, Mr. Barnes.

The Chairman. Thank you.

Mrs. Fenwick?

Mrs. Fenwick. Thank you, Mr. Chairman.

I wonder if you could give us your opinion of the effect on the dual banking system of two proposals which have been made here. Like Mr. St Germain, I very much approve of equal treatment being given for equal performance. And until we get to that position, I don't think we will have true competitive equity. So that would be one question. What effect do you think it would have on the dual banking system if across the Nation equal performance were to be given equal treatment? Second, what is your opinion of allowing these reserves to be held in interest-bearing Treasury securities, so that the reserve requirement would not, in effect, become a sort of tax in addition to other taxes that the banks carry?

Mr. BARNES. As to the first question, the whole question of equity is very difficult to deal with when you have so many different kinds of businesses operating in so many different ways. As you know, there are banks in this country who have large incomes from commercial loans and in some cases large income from foreign loans that have large international operations. You have others who are serving a narrow community and still others that are regionals. It is very difficult to establish equity for all of those, but it seems to me there should be some relationship between the rules that are imposed and the job they are doing.

So that I am not sure that this bill—in fact, I am sure that this bill does not provide that kind of equity, particularly in the cases where you have banks with large commitments to housing markets and have large savings deposits.

I think the second question is really the crux of the matter. If, in fact, reserve membership were not a burden and could be priced and compared with alternatives, each bank can make a judgment for itself as to whether it belongs in the State system or the national system, and I think you would have the best of both worlds.

I think one of the points that the committee should consider is that there is a value to having a State alternative to a national bank system. And that the value to it is that you have vital banks, larger banks, that are coming up with innovative ideas, dealing with State legislatures and introducing those ideas.

I suggest the NOW accounts didn't come from the Fed; that development in ATM's didn't come from the Fed. If you push all these larger banks that have funds for research and resources to explore new ideas into one system, I doubt it is good for the Nation. I think you would lose something in the way of vitality and new ideas.

Mrs. FENWICK. Are you saying, in other words, that the interest-bearing reserve requirement would bring about this undesired result?

Mr. BARNES. I do not. I think it would be excellent. It would provide each bank with a choice and with freedom.

Mrs. FENWICK. Thank you.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Mr. Barnes, and have a pleasant trip. We appreciate your coming here and your very helpful testimony.

Our next witness will be Owen Daly, chairman of the board, the Equitable Trust Bank, Baltimore, Md.

STATEMENT OF OWEN DALY, CHAIRMAN OF THE BOARD, THE EQUITABLE TRUST BANK, BALTIMORE, MD.

Mr. DALY. Thank you, Mr. Chairman, Congressman Steers, and Congresswoman Spellman, and other members of the committee. My name is Owen Daly. I am chairman of the Equitable Trust Co., in Baltimore and the Equitable Bancorporation, which is made up of five banks, one of which is $1½ billion, the Equitable Trust Co., and the other is a national bank, which is $120 million; two are $50 million State banks, and another is a $20 million State bank.

I would like to confine my remarks as quickly as I can to five points: One, capital formation in the banks system; two, regional bank management philosophy; three, the correspondent banking system; four, the direct effect of this bill on the Equitable Trust Co., and, five, recommendations that I would have to this committee.

First of all, capital formation: Most regional banks our size, of approximately $1½ billion, depend on earnings growth for capital formation and future loan expansion. Larger banks, including money center banks, have access to both national and international capital markets to supplement their capital.

The Federal Reserve member banks our size have dropped membership to gain benefits of nonmember banks relative to the Federal Reserve services, and to enhance earnings and capital growth, and I do stress the point of the capital growth and formation.

Regional banks management philosophy—and I will give as an example that of the Equitable Trust Co.: We are a retail bank. We have some 86 branches scattered around the metropolitan area of Baltimore, and we have had growth in the residential mortgage area and in the consumer credit area. Our clients are individuals and local businesses. Our source of funds is primarily stable and long-term consumer time deposits representing 66 percent of our total deposit structure, and this is quite significant for a large medium-size commercial bank.

Our use of funds are about 15 percent into consumer credit, 25 percent into local business lending; our mortgages are 40 percent, and our investment for liquidity purposes runs about 20 percent. Our mortgage lending represents 48 percent of our total loan portfolio of over $1 billion. That is again unusual for a commercial bank in a metropolitan area.

The head of our real estate department is chairman of the executive committee, American Bankers Association Housing and Real Estate Division, and his No. 2 man is the chairman of the Mortgage Bankers Association—Maryland chapter. I mention this to give you an indication of the prominence that we have in the mortgage banking business in the banking industry.

We have 119 branches in our holding company, the Equitable Bancorporation. Although we are not the largest bank in Maryland, we have the largest clearing in the Baltimore clearinghouse. This is because of our high retail orientation, where we have many of the blue collars and Mr. America clients in the wholesale and the business area.

We have a large investment portfolio with concentration in Maryland tax-exempt issues, which functions as a reserve under the State requirements.

Let me address myself to the correspondent banking system which grew under our dual banking system over the last 100 years. The Equitable Trust Co. services a substantial number of smaller banks in regions through deposit relationship providing credit analysis, investments analysis, check clearing, computer services, and I stress loan participation and credit risk sharing.

Let me give you an example. A large mortgage loan is requested at a local bank in a smaller community. Their capital funds are not sufficient to allow them to participate or even make a mortgage that would approximate a quarter of a million dollars. They look upstream to their correspondent for advice on a loan of this magnitude and, of course, not only for advice but also the ability to participate and share the risk.

The result is the small banks in the outlying communities in the State of Maryland are better able to service their local community by making larger loans than they would otherwise be allowed to do and sharing the risk with larger banks in the city.

We of the Equitable Trust Co., as a nonmember bank also participate in some of our larger loans upstream to some of your major money center banks throughout the country. If H.R. 14072 is law, the Equitable Trust Co. first would have to restrict its mortgage lending. It would have to reduce the holding of its Maryland bonds, which serve as reserves for our savings and our time deposits, and it would have to reduce, of course, the upstream balances to our correspondents and hence restrict our ability to participate in loans.

If we have this law enacted, based on our 5-year plan, it would cost us in reserves approximately $70 million, and we anticipate at this time that we would have a loss of pretax income of $4.8 million in 5 years.

When I mentioned initially that one of the major concerns of the banking industry is capital and equity formation, as you gentlemen know, the equity ratio to total assets has been declining in our industry, and I daresay when you impact the earnings, which is a primary source for equity formation, you are going to do a great disservice to the banking industry.

I would make the following recommendations:

No. 1, do not limit capital formation of nonmember banks.

No. 2, do not restrict a traditional correspondent banking system which has served the communities of this country well for over 100 years.

No. 3, enhance capital growth of medium-size member banks by reducing reserve requiremnts or pay interest on reserves.

No. 4, direct reporting by nonmember banks to allow the open market committee to operate in controlling the money supply.

And No. 5, recommend the pricing of services by Federal Reserve.

Thank you, Mr. Chairman.

[The following exhibits were submitted by Mr. Daly for inclusion in the record:]

EQUITABLE BANCORPORATION

EXHIBIT A

TO Owen Daly, II, Chairman of the Board

FROM John G. Evans, Senior Vice President

DATE September 22, 1978

IN RE: Banking Committee Hearings

Outline of general comments before the House Banking Finance and Urban Affairs Committee on September 22, 1978, regarding H.R. 14072.

Overview

- FED has problem retaining/attracting membership of medium sized banks ($1-2 billion)
- FED has debated need for maintinaing the present level of member bank reserves to effectively control money supply (member banks represent 73% of all commercial bank deposits down from 80% in 1970).
- All regulated industries have State Commission, i.e., public service, insurance, hospital cost and bank commissions because of local problems and needs.

Medium-sized banks - why a problem?

- Cost of membership (amount of sterile money in form of reserves to size of assets) does not provide sufficient benefits of liquidity and services to compete effectively with larger banks.
- Regional banks now must compete head-on with larger money market banks (loan producing offices/ETC/debt. - credit cards/ etc.
- Money center banks have access to national and international credit markets to finance capital for expansion.
- Regional banks rely primarily on earnings growth and local shareholders for capital.
- Money center banks have asset base to expand worldwide where there has been greater profit potential (Citibank 82% earnings are foreign).

HR 14072 - effect on Equitable Trust Bank

Based on 6/30/78 deposit data

- Raise within four years, 42 million for reserves (70 million based on 5 year plan)
- Reduction of pre-tax earnings in fourth year of $2.8 million ($4.8 million based on 5 year plan)

Options to implement HR 14072

- Curtail residential mortgage loan growth as per 5 year plan
- Liquidate in part State and Local bond portfolio (90 million are Maryland issues)

- Reduce correspondent relationships

- Join FED

- Give up State charter in favor of National charter

Why National vs. State charter?

- Comptroller of Currency historically reacts quicker to banking changes and needs at times

- Occasionally can charge higher rates vs. State laws (Citibank residential mortgage rate now 7-3/4% (discount rate) plus 1, whereas New York Usury law is 8-1/2%.

- Regulatory clearances are more expeident

- If other larger Maryland State banks change charter - State Banking Office will lose effective control and prestige.

- Greater legal lending limit (capital, surplus and undivided profits)

Why join FED?

- Buy full benefits with required reserves.

Long range implication

- Dual banking system weakened and possibly eliminated over time as reserve requirements are mandated for smaller banks.

- For Maryland (other states also) reduction of heavy investment principally by State banks in local communities via State and local bonds (300 million in principal amount of Maryland issues now in portfolio of 4 largest non-member, state chartered banks - ETC holds 90 million)

- Eventual concentration of banking power at Comptroller of Currency at a time when across State line branching is being considered; at a time when State Banking Departments weakened; elimination of necessary checks and balances to protect local banking needs.

- Possible mass merger of state banks with larger national banks because of weakened State banking department and money center competition (Canadian banking concentration)

Conclusion

- Question the economic theory that reserves of member banks equal money supply control (Fed proposing now to reduce reserve requirements of member banks and eliminate reserve of eurodollar deposits).

Solutions

- Reduce member bank reserves or pay interest on reserves to equalize medium bank exit of FED.

EXHIBIT B

EQUITABLE BANCORPORATION

TO Owen Daly, II, Chairman of the Board

FROM John G. Evans, Senior Vice President

DATE September 22, 1978

IN RE: Bank Committee Hearings

Outline of remarks before the House Banking, Finance and Urban Affairs Committee on September 22, 1978, regarding H.R. 14072.

A. Introduction

1) Capital formation
2) Regional bank management philosophy
3) Correspondent banking system
4) Direct effect on Equitable Trust Company
5) Recommendations

B. Capital Formation

1) Most regional banks our size (± 1.5 billion assets) depend on earnings growth for capital formation and future loan expansion.

2) Larger banks (including money center banks) have access to both national and international capital markets to supplement capital.

3) FED member banks our size have dropped membership to gain benefits of non-member banks relative to FED services, to enhance earnings and capital growth. (Larger FED member banks have not dropped).

C. Regional banks management philosophy - Equitable for example

1) We are retail - not wholesale

2) Clients are individuals and local business

3) Source of funds is primarily stable and long term consumer time deposit (66%) - not New York money market.

4) Use of funds

   a) Consumer credit - 15%
   b) Local business lending - 25%
   c) Mortgages - 40%
   d) Investment (liquidity) - 20%

5) Mortgage lending represents 48% of total loan portfolio vs. State average of 30%; cannot use New York "hot money" to fund long term residential mortgages.

   a) Mr. Robert Irving, Sr. V.P. of ETC - Chairman of Mortgage Committee of ABA
   b) Mr. Charles Effinger, V.P. of ETC - Chairman of Maryland Mortgage Bankers

6) Structure

   a) 119 branches in Holding Company
   b) Largest volume of check clearing in State
   c) Large investment portfolio with concentration in Maryland tax exempt issues - eligible as reserves for time deposits, under State Banking Law.

D. Correspondent System

   1) Equitable services substantial number of smaller banks in region through deposit relationships, providing

      a) Credit analysis
      b) Investment advise
      c) Check clearing/computer services
      d) Loan participation and credit risk sharing

   2) Example - large mortgage loan request at local bank

      a) ETC advises
      b) ETC participates in underwriting loan
      c) ETC shares in the credit risk

   3) Result - small bank services local community making loan larger than lending limit.

   4) ETC upstream correspondents

      a) We participate up our larger loans on the same basis.

E. If HR 14072 is law, ETC must

   1) restrict residential mortage lending
   2) reduce holdings of Maryland bonds
   3) Reduce upstream correspondent balances

   so that we can fund, based on Equitable's 5 year plan

   1) 70 million reserve requirements in 4 years
   2) loss of 4.8 million of pre-tax earning power to supplement capital formation

Recommendation (problem is member <u>and</u> non-member medium size banks)

   1) Do not limit capital formation of non-member banks.
   2) Do not restrict traditional correspondent banking system.
   3) Enhance capital growth of medium size member banks by reducing reserve requirements or pay interest on reserves.
   4) Direct reporting to FED by non-member banks of deposits - reserves.
   5) Price FED services.

The CHAIRMAN. Thank you very much, Mr. Daly.

Our next witness is H. Lee Boatwright, president, Suburban Trust Co., Hyattsville, Md.

STATEMENT OF H. LEE BOATWRIGHT, PRESIDENT, SUBURBAN TRUST CO., HYATTSVILLE, MD.

Mr. BOATWRIGHT. Thank you, Mr. Chairman, and distinguished members of the committee.

Mrs. SPELLMAN. I wonder, Mr. Chairman, if I might not say that for years my family banked in that Hyattsville bank, so I have very fond feelings toward this association, and I am happy to see Mr. Boatwright here.

Mr. BOATWRIGHT. Thank you very much.

The CHAIRMAN. Mr. Boatwright.

Mr. BOATWRIGHT. I am pleased to be given the opportunity to express my views on H.R. 14072, a bill which, if enacted, would have significant effect on my bank's earnings, on the community which we serve, and on the very structure of the banking system as we know it today.

Suburban Trust Co., a State-chartered nonmember bank, is a retail bank serving principally the Maryland bedroom communities of Washington, D.C. Of our 61 branches, 48 are located in Montgomery and Prince Georges Counties. Our deposits total just over $1 billion, and loans, most of which are consumer oriented, are averaging some $690 million.

Using the reserve requirements contemplated under H.R. 14072 and applying that formula to our reported deposit levels as of June 30, 1978, we estimate that we would be required to maintain in sterile deposits with the Federal Reserve approximately $28,400,000. Since reserves with the Fed cannot be looked upon as providing liquidity, we have assumed that these requirements will be funded equally from our municipal bond and loan portfolios. The potential effect on earnings is dramatic. Under these assumptions, net earnings will decrease by $1,330,000 and earnings per share by 30 cents, a decrease of 11.9 percent, based on last year's earnings. Obviously, such a reduction in earnings could translate into a similar reduction in the market price of Suburban Bancorporation stock, perhaps as much as $2 per share, based on present price-earnings ratios. I should add that the reductions in both earnings and stock price seriously inhibit our ability to raise the capital necessary to support the growth of our community through either retained earnings or new equity issues. Please note also that these figures give no effect to the possible additional cost of explicit pricing of services by the Federal Reserve, as this is an unknown.

It is readily apparent that our 7,000 individual stockholders, the vast majority of whom are local citizens, will expect management, during the phase-in period, to take whatever action possible to offset the impact on earnings described above. Hard choices will have to be made.

As already mentioned, part of the funding will, of necessity, come from our loan portfolio, the principal source of every bank's earnings.

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Consideration will be given to shifting to higher yielding loans, reducing the quality of the portfolio.

Because of its retail orientation, Suburban Trust has always been a heavy provider, by comparison to most banks its size, of home mortgages. In fact, Suburban now has also $195 million in single-family, residential mortgages on its books. These loans are typically of the highest quality but have the disadvantage of relatively low yields and illiquidity. We most assuredly would be forced to curtail our activities in home financing.

A second lending area which would likely feel the pinch is that of student loans. Suburban Trust is the fourth largest lender in the Nation to students under the Federal program. We will have outstanding some $7,500,000 to over 6,000 students by the end of this month.

In addition to shifts in lending activities, efforts will be made to seek out and curtail services which, while benefiting the public, are provided at a loss. For example, Suburban Trust Co. is the only bank in Montgomery and Prince Georges Counties which participates as an issuer in the Government food stamp program. This public service costs us in excess of $100,000 per year in direct expenses alone.

At this time, it is impossible to say precisely how we will adjust to meet this challenge, if required to do so. I simply point out some of the possibilities. Further study will be required. It is clear, however, that whatever the changes, our ability to serve our community will be reduced.

Now, let me turn to the other half of the equation. Under Maryland law, we are permitted to maintain a portion of our reserves in Maryland State and municipal obligations. We would expect to liquidate some of these holdings. No doubt the same would be true of other similarly affected banks. This reduction in demand would, in all likelihood, increase the cost of borrowing for the State of Maryland and its municipalities.

One further item for your consideration: With the membership dues paid, there would be a strong motivation to take advantage of all Fed services by joining, probably by way of a national charter. If the four other largest nonmember banks feel the same—and I think they do—the State banking commission will lose its principal source of funding. Only through new sources of funding will the commission be able to maintain the levels of staffing and competency needed to supervise the smaller banks effectively. I might add that 80 of the 112 banks in Maryland are nonmembers.

In conclusion, the effects of H.R. 14072 will be devastating to a number of banks such as ours, and to their ability to render the same level of service to the community. Moreover, the bill has the potential for significantly changing the banking structure, imperiling the traditional dual banking system and, perhaps, also the correspondent network as we know it today. In the absence of compelling evidence—and it is absent, in my opinion—that such drastic action will enhance the Fed's ability to conduct monetary policy, I urge you to reconsider this bill and to encourage the Federal Reserve to use the tools already available to solve its problem of declining membership; namely, a reduction in reserve requirements for member banks.

Thank you very much.

[Mr. Boatright's prepared statement follows:]

Testimony by H. Lee Boatwright, III September 22, 1978

Mr. Chairman and distinguished members of the House Committee on Banking:

I am pleased to be given an opportunity to express my views on House Resolution 14072 - a bill which, if enacted, would have significant effects on my bank's earnings, on the community which we serve, and on the very structure of the banking system as we know it today.

Suburban Trust Company, a state-chartered trust company, is a retail bank serving principally the Maryland bedroom communities of Washington, D. C. Of our 61 branches, 48 are located in Montgomery and Prince George's Counties. Our deposits total just over one billion dollars and loans, most of which are consumer oriented, are averaging some $690,000,000.

Using the reserve requirements contemplated under HR 14072 and applying that formula to our reported deposit level as of June 30, 1978, we estimate that we would be required to maintain in sterile deposits with the Federal Reserve approximately $28,400,000. Since reserves with the Fed can not be looked upon as providing liquidity, we have assumed that these requirements will be funded equally from our municipal bond and loan portfolios. The potential effect on earnings is dramatic. Under these assumptions, net earnings will decrease by $1,330,000 and earnings per share by 30¢, a decrease of 11.9% based on last year's earnings. Obviously, such a reduction in earnings would translate into a similar reduction in the market price of Suburban Bancorporation stock, perhaps as much as $2 per share, based on present earnings ratios. I should add that reductions in earnings and stock price seriously inhibit our ability to raise capital necessary to support the growth of our community through retained earnings new equity issues. Please note also that these figures give no effect to the possible additional cost of explicit pricing of services by the Federal Reserve, as this is an unknown.

It is readily apparent that our 7,000 individual stockholders, the vast majority of whom are local citizens, will expect management, during the phase-in period, to take whatever action possible to offset the impact on earnings described above. Hard choices will have to be made.

As already mentioned, part of the funding will, of necessity, come from our loan portfolio, the principal source of every bank's earnings. Consideration will be given to shifting to higher yielding loans, reducing the quality of the portfolio.

Because of its retail orientation, Suburban Trust has always been a heavy provider, by comparison to most banks its size, of home mortgages. In fact, Suburban now has almost $195 million in single-family, residential mortgages on its books. These loans are typically of the highest quality but have the disadvantage of relatively low yields and illiquidity. We most assuredly would be forced to curtail our activities in home financing.

A second lending area which would likely feel the pinch is that of student loans. Suburban Trust is the fourth largest lender in the nation to students under the Federal program. We will have outstanding some $7,500,000 to over 6,000 students by the end of this month.

In addition to shifts in lending activities, efforts will have to be made to seek out and curtail services which, while benefiting the public, are provided at a loss. For example, Suburban Trust Company is the only bank in Montgomery and Prince George's Counties which participates as an issuer in the Government Food Stamp Program. This public service costs us in excess of $100 thousand per year in direct expenses alone.

At this time it is impossible to say precisely how we will adjust to meet this challenge, if required to do so. Further study will be required. It is clear, however, that whatever the changes, our ability to serve our community will be reduced.

Now, let me turn to the other half of the equation. Under Maryland law, we are permitted to maintain a portion of our reserves in state and municipal obligations. We would expect to liquidate some of these holdings. No doubt, the same would be true of other similarly affected banks. This reduction in demand would, in all liklihood, increase the cost of borrowing for the State of Maryland and its municipalities.

One further item for your consideration. With the membership dues paid, there would be a strong motivation to take advantage of all Fed services by joining, probably by way of a national charter. If the four other largest non-member banks feel the same (and I think they do), the State Banking Commission will lose its principal source of funding. Only through new sources of funding will the Commission be able to maintain the levels of staffing and competency needed to enable it to effectively supervise the smaller banks.

In conclusion, the effects of HR 14072 will be devastating to a number of banks such as ours, and to their ability to render the same level of service to the community. Moreover, the bill has the potential for significantly changing the banking structure, imperiling the traditional dual banking system and, perhaps, also the correspondent network as we know it today. In the absence of compelling evidence (and it is absent, in my opinion), that such drastic action will enhance the Fed's ability to conduct monetary policy, I urge you to reconsider this bill and to encourage the Federal Reserve to use the tools already available to solve its problem of declining membership - namely, a reduction in reserve requirements for member banks.

Mr. St Germain [presiding]. Thank you, Mr. Boatwright.

Mr. Stanton?

Mr. Stanton. Mr. Chairman, I wanted to explain to the panel that Mr. Reuss and I have the International Monetary Fund conference with the Senate, but we will be back shortly thereafter.

Mr. St Germain. The panel, I am sure, realizes that the members unfortunately have to be at more than one place at the same time, but I think we are fortunate in having as many members as we have this morning because of the conference committees going on, but we want to give you as much attention as possible.

We will now hear from Robert M. Foster, vice president of the Arlington Trust Co. in the neighboring State of Massachusetts, and the city of Lawrence.

STATEMENT OF ROBERT M. FOSTER, SENIOR VICE PRESIDENT, ARLINGTON TRUST CO., LAWRENCE, MASS.

Mr. Foster. Mr. Chairman, other distinguished members of the House Banking Committee, my name is Robert M. Foster, and I am with the Arlington Trust Co. in Lawrence, Mass.

We appreciate your courtesy in allowing us to be here. We have submitted a statement, as the others have, and my comments will be brief, the statement already having been submitted.

I appreciate the prior comments of Congressman St Germain and of Mr. Barnes, Mr. Daly, and Mr. Boatwright.

I would like to say, if you have a feeling of deja vu as I talk, there has been no preconceived plot. This has come individually and spontaneously.

Arlington Trust Co. is a $450 million State nonmember bank with about 60 percent of its deposits in regular savings and term savings deposits of individuals. Approximately 70 percent of our loan portfolio consists of residential home mortgages and consumer loans.

I would like to point out in this connection that Massachusetts commercial banks face stronger competition from thrift institutions than do banks in many other sections of the country and in some ways, the Arlington Trust Co., like the Old Stone Bank, resembles a large thrift institution, although we have always been a commercial bank.

We have not converted from a thrift institution, but I think there is a special situation in Massachusetts for all banks, but particularly for banks of the deposit and loan mix that we have at the Arlington Trust Co., which urgently cries for consideration in the deliberations of this committee. The deposits of all Massachusetts' commercial banks were about $15 billion as of March 31 of this year. The deposits of the Massachusetts savings banks at the same time were about $19 billion, substantially more than that of the commercial banks. In addition, savings and loans associations, including Massachusetts cooperative banks, have deposits in excess of $6 billion.

Now, in some States of the country you would say that is not apropos or germane to the discussions today, but under Massachusetts law thrift institutions now offer the full range of financial services to consumers, and they are the principal customers at our banks, including NOW accounts, personal loans, automobile loans, revolving credit and overdraft privileges through the credit card, collateral loans, pay by phone, automated teller services, and the list goes on and on.

In other words, the Massachusetts thrift institutions now are department stores of banks, completely competitive with the commercial banks for financial services to the individual and paradoxically still enjoy the rate differential provided by regulation 2. The historical justification has been that the thrift institutions have a narrower range of services than the commercial banks.

Chairman G. William Miller was recently quoted as saying that the Fed seeks to lower the level of handicapping among all banks and to level the competitive environment between member banks and nonbanking institutions which have gained banking powers.

In our opinion, passage of the bill in question in essentially the form that we understand it to be proposed would in Massachusetts tend to heighten further the level of handicapping in favor of the powerful thrift institutions of the State.

Just one brief comment: Information regarding the imminence of this proposed legislation has come to us fairly recently. We have not had time to suggest any well-thoughtout alternatives, and we feel that study at much greater length is indicated in order to achieve the proper objectives of the Federal Reserve System, including the cost-effective implementation of monetary policy.

We are somewhat imperfect, and it may be that we should have been alerted sooner to study the changes proposed by your honorable committee, but, in any event, we have not.

We would like to point out, too, and I think this is a matter that has to do with the many and powerful thrift institutions, I think approximately one-third of the mutual savings banks in the country are in Massachusetts in substantial part because of competition with the thrifts. Massachusetts ranks 50th in the Nation in profitability in the commercial banks. We are apprehensive about the effect on banks like ours, in any event. If this additional nail is put in the coffin, so to speak—I don't mean to sound too extreme—but our controller's best estimate of the effect of this proposed legislation on our bank would be it would reduce pretax earnings by about $979,000, and after tax earnings by about $445,000.

Our earnings in the last few years have averaged about $2 million, maybe slightly under, so this is a significant bit of legislation for us. It would withdraw from our capabilities of lending largely to consumers about $11 million.

Thank you, Mr. Chairman, and members of the committee.

[The following letter from Daniel J. Murphy, president of the Arlington Trust Co., of Lawrence, Mass., was received by the committee for inclusion in the record:]

Arlington Trust company
P.O. Box 688
LAWRENCE, MASSACHUSETTS 01842

September 21, 1978

The Honorable Henry S. Reuss, Chairman
House Committee on Banking, Finance and Urban Affairs
Washington, D.C.

Dear Mr. Reuss:

We at the Arlington Trust Company are strongly opposed to the enactment of H.R. 13847 as it relates to the revision of required reserves held at the Federal Reserve Bank.

Arlington Trust Company is a $450 million state non-member bank with 60% of its deposits in stable regular savings and term savings deposits. The net effect of the significantly increased non-earning reserve requirements for us would be to remove approximately $11 million from our lending ability. Because 70% of our loan portfolio consists of residential home mortgages and consumer loans, much of the loan reduction would have to come from these consumer categories. There are several other Massachusetts commercial non-member banks who would be required to make reductions of similar size in their consumer loan portfolios.

Massachusetts Commercial Banks face stronger competition from thrift institutions than do banks in other sections of the country. Thrifts already enjoy a ¼ of 1% differential in savings and time rates. With no reserve requirements being established for the thrifts and the addition of 7% required reserves on savings deposits and 6% required reserves on 90 day notice accounts of consumers, we will be competing under a tremendous additional disadvantage in serving our community needs.

There is a special situation in Massachusetts which urgently cries for consideration in these deliberations. The deposits of all Massachusetts Commercial Banks were about $15 Billion as of March 31, 1978. The deposits of Massachusetts Mutual Savings Banks were about $19 Billion. In addition, Savings and Loan Associations (including Massachusetts Cooperative Banks) have "deposits" in excess of $6 Billion dollars.

Under Massachusetts Law Thrift Institutions offer the full range of financial services to consumers, including NOW Accounts, personal loans, automobile loans, revolving credit and overdraft privileges through the credit card, collateral loans, pay-by-phone, automated teller services, etc. In other words the Massachusetts Thrift Institutions are "department stores of banking" - completely competitive with commercial banks for financial services to the individual and, paradoxically, still enjoy the rate differential provided by Regulation Q, the historical justification of which has been that the thrift institutions have a range of services narrower than that of commercial banks.

The passage of this legislation, insofar as its effect on Commercial Banks in Massachusetts, creates one more severe competitive disadvantage in serving the consumer's needs.

We believe that the full implications of this Bill have not been aired as yet. The impact of shifting reserves between member and non-member banks has not been examined in the light of our presently well-working dual banking system. This Bill itself calls for the examination by the Federal Reserve Board of the impact of the new reserve requirements on savings deposits at banks; the impact of requiring thrifts to maintain reserves on transaction accounts; and the investment of reserves in Treasury securities.

Information regarding the imminence of action on this proposed legislation has come to us fairly recently. We have not had time to suggest well thought out alternatives and we feel that study in much greater length is indicated in order to achieve the proper objectives of the Federal Reserve System, including, of course, effective implementation of monetary policy.

We do not question that the Federal Reserve Board should have good control over the money supply. We would be delighted to provide any information to the Federal Reserve System for that worthy cause. However, forcing membership on a few regional consumer banks through non-earning reserves appears to us to be unfairly discriminatory.

Current reserve requirements for state non-member banks have enabled the Arlington Trust Company to serve the Northeastern Massachusetts market very well. To increase our reserves and thereby reduce significantly our earnings and capital formation in a state ranking 50th in bank earnings, while allowing our much larger and much smaller commercial bank competitors increased earning assets, does not seem fair. As mentioned, the thrifts would enjoy both rate and reserve advantages.

There must be a more equitable way of improving Federal Reserve control and implementation of monetary policy.

Sincerely,

Daniel J. Murphy, Jr.
President

Mr. ST GERMAIN. Thank you, Mr. Foster.

We will now hear from Mr. Leonard Weil, president, Manufacturers Bank, Los Angeles, Calif.

Mr. Weil?

STATEMENT OF LEONARD WEIL, PRESIDENT, MANUFACTURERS BANK, LOS ANGELES, CALIF.

Mr. WEIL. Thank you, Mr. Chairman and members of the House Banking Committee.

My name is Leonard Weil, and I am president of the Manufacturers Bank of Los Angeles, Calif.

Manufacturers Bank is a small or mediumsized bank by California standards and focuses its marketing activities almost entirely on lending to small business firms. It makes no loans at all to large national business firms.

I appreciate the opportunity to appear before the committee in order to discuss the impact of H.R. 14072. I must say, expressing my opinion, I feel the bill is not only controversial but a disaster in its destructive impact on the dual banking system which has been the world's most outstanding system for providing financing for small businesses.

H.R. 14072 addresses itself to the past and not to the present or the future. There are a couple of areas I would like to point out that are not addressed at all, but much greater consequence to the ability of the Federal Reserve System to control money supply as opposed to the almost miniscule effect of additional reserves required under this bill.

Even the printout provided by the Federal Reserve, which indicates the reserve requirements which would be imposed under H.R. 14072, is based upon 1977 figures.

Inflation continues to increase deposits in banks, so in the case of Manufacturers Bank the additional required reserves shown in the printout is $20 million.

However, our 1978 deposits would require $30 million in additional reserves, and those required reserves would continue to grow.

Even if we were to discuss the impact to Manufacturers Bank of the $30 million reserve requirement, the effect would be a disaster. Manufacturers Bank lends primarily to small business, as one of the few banks anywhere that extends credit to newly formed businesses. The average size of our new loan would be less than $50,000.

If we were to assume a 70-percent loan-to-deposit ratio, that would mean that $20 million of sterilized reserves over and above what we have been maintaining as reserves under California law would not be available for the purpose of making loans.

A sterilized $20 million would mean that 400 small business borrowers would not be able to obtain credit from Manufacturers Bank. Assuming that the small business firms have an average of 20 employees, it would mean that 8,000 jobs will be placed in jeopardy as a direct consequence of H.R. 14072, taking in consideration the effect on one bank.

I wonder if the committee has given adequate consideration to the impact of this effect.

In looking at the list of banks that will be required to maintain reserves at the Federal Reserve System under this bill, I find that most of them are medium-sized banks. Banks of this size will have a much higher concentration of loans to small- and medium-sized firms than do the larger banks whose reserve requirements will be reduced, so that the overall impact of H.R. 14072 will be to make credit scarcer and less available to small and medium-sized business firms.

Does this constitute competitive equality?

Obviously, there will also be a financial impact directly upon Manufacturers Bank and its earnings, in that, if H.R. 14072 passes and reserves called for in this bill must be maintained with the Federal Reserve System, then on a pro forma basis Manufacturers Bank would lose approximately $75,000 of gross revenue for every $1 million of required reserves, so that if required reserves are $30 million Manufacturers Bank's gross revenue would be reduced by $2,250,000.

If required reserves were $40 million, gross revenue would be reduced by $3 million. Because of the adverse effect that this would have on Manufacturers Bank's profitability, it is questionable whether it will be possible for Manufacturers Bank to maintain its marketing focus on small business and on new business.

Because of the adverse effect this would have on profitability, it is questionable whether it would be possible for Manufacturers Bank to maintain its marketing focus on small businesses and on newly formed businesses.

We feel that our focus, our market focus on small size business firms helps stimulate the economy and helps form more jobs but also encompasses more risks, and such risks might be greater than we would be willing to accept if earnings were adversely impacted by this imposition of increased sterile reserve requirements.

If the members of the committee feel that the imposition of mandated reserve requirements kept with the Federal Reserve System on medium-sized banks called for in H.R. 14072 is so socially desirable that they are willing to disregard the adverse impact which will be created for small and medium-sized business firms and on employment, then I would like to call to the committee's attention that it is not addressing itself at all to several areas which are presently not under the control of the Federal Reserve and have a greater effect on M_1 or the Nation's money supply than do all the reserves placed under the control of the Federal Reserve System by this proposed bill.

The savings and loan industry has developed a technique called telephonic transfers under which great sums are moved back and forth on a daily basis from savings and loans to banks, and then back from banks to savings and loans.

These funds are not only the funds of individuals but also include funds of corporations and business firms and the volume has grown and grown. As long as the funds are in savings and loans, they do not come under the definition of M_1 or money supply and no reserves are maintained at the Federal Reserve.

What I wish to point out is the shifting back and forth from savings and loans to banks now has a sizable effect on increases in the money supply which is in no way controlled by the Federal Reserve System. I would simply like to say the activity in the Eurodollar market has a similar effect, also not under the control of the Federal Reserve System.

For the record I would like to state that I have been requested by the board of directors of the Independent Bankers Association of Southern California and board of directors of the Independent Bankers of Northern California, two groups of approximately 195 banks in Caliornia, to express on their behalf their violent opposition to H.R. 14072 and the attempt therein to ruin the dual banking system.

I have also been asked on behalf of the board of the Western Independent Banks Association, a group of 419 banks in the 12th Federal Reserve District, to express on their behalf their violent opposition to H.R. 14072 and the damage which it does to the dual banking system.

I respectfully suggest that the committee reconsider its vote on H.R. 14072.

Thank you very much.

[Mr. Weil's prepared statement follows:]

CHAIRMAN and MEMBERS of the House of Representatives Committee on Banking, Finance and Urban Affairs:

Gentlemen:

My name is Leonard Weil and I am President of Manufacturers Bank of Los Angeles. Manufacturers Bank is a small or medium-sized bank by California standards and focuses its marketing activities almost entirely on lending to small business firms. It makes no loans at all to large national business firms. In the past I have served as President of the California Bankers Association, the Western Independent Bankers Association, a group whose members approximate 400 independent banks in the Western States. I have also served as President of the Independent Bankers Association of Southern California and I have been an instructor at the University of Southern California in the fields of Banking and Finance.

I appreciate the opportunity to appear before the Committee in order to discuss the impact of HR14072. In most aspects the Bill is not only controversial but disastrous and destructive in its effect on the dual banking system which has been the world's most outstanding system for providing financing for small businesses.

HR14072 addresses itself to the past and not to the present or the future. The print-out provided by the Federal Reserve, which indicates the reserve requirements which would be imposed under HR14072, is based upon 1977 figures. In the case of Manufacturers Bank, 1978 would mean required reserves of $30,000,000 and obviously, assuming that the inflation continues we will see increased money supply and a greater volume of deposits for banks by 1979-80, so that the required reserve figures will be much greater. But even if we were to discuss the impact to Manufacturers Bank of the $30,000,000 reserve requirement, we would have to regard the effect as a disaster. Manufacturers Bank is engaged primarily in lending to small businesses and is one of the few banks anywhere that extends credit to new businesses. The average size of our new loan would be less than $50,000. If we were to assume a 70% loan-to-deposit ratio, that would mean that $20,000,000 of sterilized reserves over and above what we have been maintaining as reserves under California law would not be available for the purpose of making loans. A sterilized $20,000,000 would mean that 400 small business borrowers would not be able to obtain credit from Manufacturers Bank. Assuming that the small business firms have an average of 20 employees, it would mean that 8,000 jobs will be placed in jeopardy as a direct consequence of HR14072, taking in consideration the effect on only one bank. I am not sure that the Committee has given adequate consideration to this kind of impact as a result of the possible passage of HR14072.

In looking at the list of banks that will be required to maintain reserves at the Federal Reserve System under this Bill, I find that most of them are medium-sized banks. Banks of this size will have a much higher concentration of loans to small and medium-sized firms than do the larger banks whose reserve requirements will be reduced, so that the over-all impact of HR14072 will be to make credit scarcer and less available to small and medium-sized business firms.

Obviously, there will also be a financial impact directly upon Manufacturers Bank and its earnings in that, if HR14072 passes and reserves called for in this Bill must be maintained with the Federal Reserve System, then on a pro-forma basis Manufacturers Bank would lose approximately $75,000 of gross revenue for every $1,000,000 of required reserves; so that, if required reserves are $30,000,000 Manufacturers Bank's gross revenue would be reduced by $2,250,000. If required reserves were $40,000,000 gross revenue would be reduced by $3,000,000. Because of the adverse effect that this would have on Manufacturers Bank's profitability, it is questionable whether it will be possible for Manufacturers Bank to maintain its marketing focus on small business and on new business. Manufacturers Bank is one of the few banks anywhere that, as a matter of policy, is willing to make loans to new, recently formed businesses. We feel that such activity helps stimulate the economy and helps create more jobs, but it also encompasses more risk, and such risks might be greater than we would be willing to accept if earnings were adversely impacted by this imposition of increased sterile reserve requirements.

If the members of the Committee feel that the imposition of mandated reserve requirements kept with the Federal Reserve System on medium-sized banks called for in HR14072 is so socially desirable that they are willing to disregard the adverse impact which will be created for small and medium-sized business firms and on employment, then I would like to call to the Committee's attention that it is not addressing itself at all to several areas which are presently not under the control of the Federal Reserve and have a greater effect on M1 or the nation's money supply than do all the reserves placed under the control of the Federal Reserve System by this proposed Bill. The savings and loan industry has developed a technique called telephonic transfers under which great sums are moved back and forth on a daily basis from savings and loans to banks, and then back from banks to savings and loans. These funds are not only the funds of individuals, but also include funds of corporations and business firms and the volume has grown and grown. As long as the funds are in savings and loans, they do not come under the definition of M1 or money supply and no reserves are maintained at the Federal Reserve. What I wish to point out is the shifting back and forth from savings and loans to banks now has a sizeable effect on increases in the money supply which is in no way controlled by the Federal Reserve System. The practice continues to grow and its impact is much greater than the consequence of imposing reserve requirements on the non-member medium-sized banks of the country.

The Committee has also not taken into consideration the effect of movements in the Eurodollar markets on money supply in the United States. Estimates of the size of Eurodollar markets run as high as $500,000,000,000, compared to total deposits of $900,000,000 in all the banks of the United States. Large banks and large corporations which have access to this market can shift funds back and forth with tremendous effects on the money supply which are almost completely uncontrolled by the Federal Reserve System. The sums involved in these transactions are so vast that the reserve requirements imposed under HR14072 on medium-sized banks are completely insignificant in helping the Federal Reserve to control money supply when compared to the consequences of Eurodollar activity.

HR14072 calls for the Federal Reserve to make several studies. I would respectfully suggest that mandated reserve requirements imposed under HR14072 be eliminated from the Bill and that the studies called for in the Bill, plus additional studies on the consequences of telephonic transfers between savings and loans and banks and transfers of Eurodollars be included as further studies, and that no attempt be made to legislate mandated reserve requirements for non-member banks until all the studies are completed.

For the record, I would like to state that I have been requested by the Board of Directors of the Independent Bankers of Southern California and the Board of Directors of the Independent Bankers of Northern California, two groups of approximately 195 banks in California, to express on their behalf their violent opposition to HR14072 and the attempt therein to ruin the dual banking system. I have also been asked on behalf of the Board of the Western Independent Bankers Association, a group of almost 400 banks in the Twelfth Federal Reserve District, to express on their behalf their violent opposition to HR14072 and the damage which it does to the dual banking system. I respectfully suggest that the Committee reconsider its vote on HR14072.

Thank you very much.

Mr. St Germain. Thank you, Mr. Weil.

We will now hear from Walter Johnson, president, Allied Bank of Texas, Houston, Tex.

Mr. Johnson?

STATEMENT OF WALTER JOHNSON, PRESIDENT, ALLIED BANK OF TEXAS, HOUSTON, TEX.

Mr. Johnson. Thank you, Mr. Chairman.

Mr. Chairman and distinguished committee members, my name is Walter Johnson, president of the Allied Bank of Texas. We are an $850 million Houston bank.

We organized some 22 years ago under a State charter and under that system have grown to be Texas' largest bank and the 10th largest bank in the entire Nation.

Our customers are exclusively the regional middle market companies. The State charter has permitted us to better serve the needs of this important segment of our local economy by having a larger loan limit. We have been aggressive lenders who specialize in the small to medium size business and we have no national accounts.

We have no foreign loans; we don't do any international lending. We only help the struggling, small, medium-sized businessman, and helping that segment of the economy has gained us the position as the largest State bank in Texas.

I am appreciative of the recent visits with Chairman Reuss and his committee and am pleased with his genuine concern for the banking industry coupled with his interest in solving a concern that both he and I share regarding the diminishing strength of the Fed.

I am personally one of the Fed's staunchest supporters and shudder at the condition the country might be in today had it not been for the monetary policy exerted by former Chairman Burns and now Chairman Miller who I know recognizes the need for a strong monetary policy when we lack adequate fiscal restraint to solve the very grave problem of inflation.

The bill under consideration has some features I find plausible. However, I do not think my bank or the banking system as a group can live with it as presented and I am thoroughly convinced that it will not satisfactorily achieve the objective Congress intends.

My bank will be the most affected of all Texas banks. We must idle some $14 million in cash with the Fed which will negatively impact our earnings in excess of $1 million and is of concern to our 8,000 shareholders as well as my board of directors. However, this is not the issue I want to focus on.

The issue is this bill will shift the burden of reserve requirements and monetary controls on about 10 percent of the Nation's banks and lets the other 90 percent off scot-free, and this is not equitable.

I panic to think what kind of restrictions could be imposed on this minority of the Nation's banks in periods of tight money or other monetary crises.

The political imbalance that would be created could be disastrous when we find 90 percent of the unaffected banks supporting legislation that could have material effects on this minority of reserve banks.

Every day our bank is losing deposits to other financial institutions, namely savings institutions and credit unions, yet they are totally dismissed from any reserve requirements under this bill.

It is obvious that this omission will eliminate the legislature's ability to deal with the questions of fair competition and regulation of this growing sector of the American Monetary System.

Virtually every banker I have canvassed strongly contends that the Fed's objective cannot be reached without the inclusion of all financial institutions.

If this bill passes it will probably destroy the dual banking system of State banks that has been effective for some 200 years because every State bank of any size would find it advantageous to join the Fed when they have been forced to pay the price anyway through mandatory reserves.

State banks haven't been getting a free ride and State bank membership has some costly disadvantages:

One. We are not permitted to have foreign offices.

Two. We cannot participate in the Eurodollar market as an alternate source of funds.

Three. We are not permitted to issue certificates of deposit in the secondary CD market as national banks can.

Four. Instead of one bank examination a year, we average three or four examinations yearly from two different agencies that cost both hard dollars and soft dollars from fees and soft dollars from staff time and disruption.

Mr. St Germain. You say you average three or four bank examinations in Texas?

Mr. Johnson. Yes.

Mr. St Germain. By whom?

Mr. Johnson. The FDIC examines us three times every 2 years and the State banking departments have to examine us three times every 2 years. That will work out to an average of better than three times a year. So far this year I have had two State examinations. Our cost of those two examinations has been $175,000.

The FDIC will probably be in before yearend and probably cost me another $80,000 or $90,000.

Mr. St Germain. You are telling me FDIC gets to your bank three times every 2 years?

Mr. Johnson. Yes, sir.

Mr. St Germain. They have been doing that over a period of years?

Mr. Johnson. Yes, sir.

Mr. St Germain. Thank you.

Mr. Johnson. As a State bank our capital requirements are significantly greater than large national banks.

These and numerous other tangible and intangible cost of our remaining a State bank are totally offset by our ability to maintain our balances and reserves with very large national banks to compensate them for their many services to us. They, in turn of course, clear their items and maintain reserves on their deposits with the Fed.

Our customers are exclusively regional, middle market companies. The State charter permits us to better serve the needs of this important segment of our local economy by having a larger loan limit.

It seems to me an alternate to the bill could be payment on reserves to encourage membership or simply a reduction in reserve requirements as proposed by this legislation which the Fed apparently finds acceptable. This bill reduces by $13.2 billion the total reserves by the Fed. This alone could prove to be incentive enough to stop the Federal Reserve's declining membership.

I feel strongly that approval of this legislation without adequate consideration of the negative implications bankers are posing today and without consideration of some viable alternatives that may solve the problems without destruction of the dual banking system is definitely a mistake.

Thank you, sir.

Mr. St Germain. Thank you, Mr. Johnson.

We will now hear from A. Harrel Blackshear, president, Western Bank of Houston, Tex.

STATEMENT OF A. HARREL BLACKSHEAR, PRESIDENT, WESTERN BANK, HOUSTON, TEX.

Mr. Blackshear. Mr. Chairman and members of the House Banking Committee, my name is A. Harrel Blackshear.

I appreciate being included in this illustrious panel of banks. I feel, pardon the phrase, we are peanuts compared to the other banks that are represented here.

Our deposits run $135 million. Our earnings will be impacted if we are mandated to carry sterile reserves with the Federal Reserve System.

At the present time it will cost us something over $150,000 pretax, but since we intend to grow faster than the rate of inflation that impact will increase over the years.

We are in a very competitive environment in Houston, being a nonbranching State. We compete with some 150 banks in Houston and, of course, this additional tax or impact on our earnings will put us at a disadvantage with some of our competitors.

I am going to keep my remarks brief, proportionate to our size.

I don't know whether any of the other members of this panel were formerly a national bank. Our bank was a national bank until 1974. We took a hard look at what the Fed was doing for our bank and we could find no reason to remain a member, so we exercised our freedom of choice and became a State bank. We were not disadvantaged in any way by leaving the Fed. As a matter of fact, we were helped because it did free up some sterile reserves.

I, of course, don't like the idea of being forced back into the Fed by mandate.

I wish that we had more time. I think most of the remarks from the bankers here have been negative. I think if we had a bit more time we could come up with some positive things rather than negative things in regard to the Fed's dilemma over their loss of membership.

I am against the bill. I hope that you will give it further consideration and perhaps the bankers represented here today can come up with some positive ideas and suggestions that may help make an equitable bill out of H.R. 14072.

Thank you, Mr. Chairman.

[Mr. Blackshear's prepared statement follows:]

TESTIMONY BEFORE THE HOUSE BANKING COMMITTEE
IN OPPOSITION OF HR14072

MY NAME IS A. HARREL BLACKSHEAR AND I AM PRESIDENT OF WESTERN BANK, HOUSTON, TEXAS, A SUBURBAN BANK WITH DEPOSITS OF $135,000,000.00. I AM ONE OF THE MINORITY OF 250 BANKS THAT WOULD BE DAMAGED IF HR14072 IS PASSED. ACCORDING TO MY CALCULATIONS BASED UPON MY UNDERSTANDING OF THE BILL, MY STERILE RESERVE REQUIREMENT WOULD BE APPROXIMATELY $1,800,000.00 IN THE FOURTH YEAR WHICH, BY USING CURRENT FED FUND RATES, WOULD RESULT IN THE LOSS OF APPROXIMATELY $153,000.00 IN INCOME. ALTHOUGH THIS MAY NOT SOUND LIKE A GREAT AMOUNT TO MANY, IT IS A SIGNIFICANT AMOUNT TO OUR BANK. UNDER THE S3485, AS I UNDERSTAND IT, OUR STERILE RESERVE WOULD BE $2,166,000.00 AND OUR LOSS OF INCOME PER ANNUM WOULD BE $184,000.00. OUR BANK WAS A NATIONAL BANK UNTIL JULY, 1974 AT WHICH TIME WE CONVERTED TO A STATE BANK EXERCISING THE EXISTANT FREEDOM OF CHOICE. OUR REASON FOR LEAVING THE FEDERAL RESERVE SYSTEM WAS THAT WE WERE BEING FURNISHED ABSOLUTELY NO SERVICES WHATSOEVER AND WERE TOLD NOT TO EXPECT ANY SERVICES FROM THE FEDERAL RESERVE BUT TO GO TO OUR CORRESPONDENTS FOR CLEARANCE OF OUR CASH LETTERS. THIS ATTITUDE ON THE PART OF THE FED OF NOT GIVING SERVICES BOTHERS ME IN THAT UNDER THE BILL THE SAME ATTITUDE COULD CONTINUE BY PRICING THEIR SERVICES ABOVE THOSE OF OUR CORRESPONDENT BANKS. OUR BANK DOES NOT BORROW MONEY AND THEREFORE, THE ACCESS TO THE DISCOUNT WINDOW IS AN ARGUMENT THAT HAS NO VALIDITY. WE FURTHER RESENT THE LARGER BANKS

REAPING WINDFALL PROFITS FROM THIS BILL, PARTICULARLY SINCE THEIR REQUIRED CAPITAL PERCENTAGES ARE MUCH LOWER THAN OURS. WE FURTHER RESENT THE HASTE IN WHICH THIS BILL WAS PUT TOGETHER AND THE INSUFFICIENT TIME GIVEN US TO ANALYZE ITS ASPECTS WITH RESPECT TO OUR INDIVIDUAL INSTITUTION. I AM A STRONG BELIEVER IN THE DUAL BANKING SYSTEM AND FURTHER FEEL THAT IF THIS BILL IS PASSED IT WOULD SERIOUSLY EFFECT THAT SYSTEM WHICH HAS SERVED US SO WELL FOR SO LONG. THE ARGUMENT THAT THE BILL WILL GIVE THE FEDERAL RESERVE A BETTER MANAGEMENT OF MONETARY POLICIES IS NOT CREDITABLE TO ME. FOR EXAMPLE, EVERY TIME THE FED MOVES THE FED FUND RATES UP OR DOWN OUR BANK ALMOST IMMEDIATELY CHANGES ITS RATES ON LOANS AND CERTIFICATES OF DEPOSIT. THE FED CERTAINLY HAS CONTROL OF INTEREST RATES WHICH IS ONE OF THE PRINCIPAL DETERMINANTS OF MONETARY POLICY. FURTHER, WE UNDERSTAND THAT ANOTHER PROVISION OF THE BILL WILL REQUIRE MORE REPORTS FROM OUR BANK. WE SPEND A LARGE AMOUNT OF TIME NOW IN REPORTING TO VARIOUS FEDERAL AGENCIES WHICH IS A COSTLY PROCESS AND AT TIMES WE FEEL THAT IT IS MERELY AN EXERCISE WITH THE INFORMATION NOT BEING USED. IN SUMMATION, WE FEEL THAT OUR BANK IS BEING DISCRIMINATED AGAINST IN THAT IT WILL BE HARMFUL TO OUR EARNINGS, AND THAT WE ARE BEING FORCED BACK INTO DOING BUSINESS WITH THE FEDERAL RESERVE AFTER HAVING HAPPILY LEFT IT IN 1974, AND DESPITE ALL THE PROTESTATIONS OTHERWISE, WE FEEL THAT IT IS MORE GOVERNMENT CONTROL IN OUR INDUSTRY WHICH IS UNWARRANTED AND WILL GROW OVER THE YEARS.

Mr. St Germain. Thank you, Mr. Blackshear.

I would like to observe one thing in response to what you just stated, Mr. Blackshear.

The purpose of this legislation or the stated purpose of the legislation is not new, it didn't arise 6 months ago, a year ago, or at the beginning of this Congress.

I have been here for quite a period of time and Arthur Burns wore a path from the Fed to my office year after year asking for assistance in this dilemma and so all we have had is outright opposition and very little constructive suggestions.

Mr. Blackshear. Yes, sir, I realize that.

Mr. St Germain. As I say, it is not a brandnew proposition or question. It has been hanging around here for a long, long time. We just have not gotten that kind of input.

Mr. Blackshear. Yes, sir. If the Fed had offered us any kind of services or any reason to remain a member we would have remained a member. But we knew of absolutely no reason to continue on as a national bank.

Mr. St Germain. Thank you, Mr. Blackshear.

Mr. Blackshear. Yes, sir.

Mr. St Germain. You are not unique in that respect. That is, of course, what brings us to this point, the fact some banks come to that same conclusion.

Mr. Blackshear. It looks like if they could improve their services or give us a reason for being a member we would do it voluntarily and not be forced into it.

Mr. St Germain. Patriotism alone is not enough.

Now, we will hear from the other panelist.

Mr. Derrick. Mr. Chairman, would you yield just a moment?

Mr. St Germain. Certainly.

Mr. Derrick. I would like to take this opportunity to personally recognize a very close friend of mine for many years. We are delighted to have him here. W. W. Johnson is chief executive officer of Bankers Trust in South Carolina, and has been very active in good government—including your Congressman—for a number of years.

Mr. St Germain. That is a super introduction, Mr. Johnson, and with that you should be able to fly right along here.

Mr. Derrick. We are going to carry on and see how he is after this legislation.

Mr. St Germain. I might say to you, Mr. Johnson, that Mr. Derrick is not only a very distinguished member of the full committee, but he is one of the members who has labored and worn out a lot of trousers sitting with me through very long hearings, ever since he has arrived here on the Subcommittee on Financial Institutions. You are very fortunate to have a member who has taken the time, and I mean a lot of time, to acquaint himself with bank legislation as well as legislation affecting all financial institutions.

I say this, oftentimes we sit up here and compliment other members, but I can demonstrate what I state as being factual by presenting to you the record, the attendance record of this gentleman at the hearings over the years. Some of them have been very dull, but he has been there because he has always felt there was something that could come about that would be helpful to him.

Mr. Derrick. You don't have to reply to that, just give your statement.

STATEMENT OF W. W. JOHNSON, CHIEF EXECUTIVE OFFICER, BANKERS TRUST OF SOUTH CAROLINA, COLUMBIA, S.C.

Mr. Johnson. Thank you, Mr. Chairman, and thank you, Mr. Derrick. We know he is a horse down home and we are proud of him.

Mr. Chairman, Mr. Brown, and my Congressman, Butler Derrick, I am pleased to have the opportunity to express my views to you today about H.R. 14072.

In a few short minutes I will attempt to express my concerns about this proposed legislation. As I understand, the intent of this bill is to solve the crisis of inflation, the economy, the dollar, the conduct of monetary policy, and the Fed membership problems.

First, I think that is a pretty big order for one piece of legislation and, I respectfully disagree with that interpretation.

If the Congress is to solve the problem of inflation, it must put a lid on spending.

If it is to solve the problem of the dollar, it must pass an energy bill.

If it does those two things, the economy will take care of itself, in my judgment.

As for the conduct of monetary policy, I believe most economists, you may disagree on this, Mr. Chairman, some of whom will testify here today, believe that the Fed has sufficient tools presently at its disposal to conduct the monetary affairs of this country.

So this leaves us with the Fed membership problem. If one assumes that the Fed does not have a problem with monetary affairs, one can only assume that the Fed has a political problem. That is what I assume.

With fewer members, its political clout is lessened on the Hill and its autonomy is jeopardized which, I must say, concerns me. However, I don't think this bill is the answer to the Fed's problem; in fact, I think they are selling their birthright for a pot of porridge.

There are two matters of concern to me about this bill, how it affects my bank—I won't put them in order of priority—but how it affects my bank and how it affects my country. If this bill passes, it will cost my bank a heck of a lot of money.

You have already covered that and I won't go into it. Having a discriminatory tax forced upon me is not a pleasant prospect but if it comes my people and I are good enough to overcome it. This aspect of the legislation is not my greatest concern. My greatest concern lies with what this legislation does to my country.

I am just as interested in my country as any man in this room.

In the days of the Roman Empire the saying was that, "All roads lead to Rome." In America today too many politicians, in my judgment, are saying that, "All power must come to Washington," and once it gets here it must be centralized.

In my judgment, if this legislation passes, we will end up with one central power in Washington that will regulate all banking. We will end up with one Federal bureaucracy that will dominate the financial system of the United States of America.

At this moment, I cannot articulate exactly how this will evolve, but believe me it will evolve, and I don't believe this committee wants that. I know the American people don't want it. They have had enough concentration of power in Washington. The Republic was not formed by this philosophy. That is why we have the executive, the legislative, and the judicial branches of government.

I am sure that if our forefathers had known we were going to legislate a fourth branch and probably the most powerful branch, in my judgment, that is the bureaucracy, they would have provided for a division of its power. Fortunately, we have had this division of power in banking for decades and it has boded well for the American people, the economy of this country, and for the banking industry.

Chairman Miller recently discussed this legislation with a group of 300 bankers that is supposed to represent the leadership of the American Bankers Association. This group has little banks, big banks, medium-size banks, member banks, nonmember banks, State banks, and national banks.

As you may have gathered, every kind of bank imaginable is represented. My guess is that about 90 percent of those present would benefit from this proposed legislation. But you know what, about 90 percent of those present at that meeting would benefit from this legislation at the bottom line. But about 90 percent of those bankers present oppose the legislation.

Now, that is hard for you to imagine, but it isn't hard for me to imagine, because I know these men have the same fear I have, the same fear most Americans have, they fear the centralization of power in one Federal bureaucracy.

At this meeting I told Chairman Miller that the vast majority of those present were concerned with the possible elimination of the dual banking system and with the concentration of power in a single Federal agency.

I asked him if he shared the same concern. I don't mean this disparagingly but I don't think he answered my question directly, that is, as I understood him.

He did say that most other countries of the world operated with only one regulatory body. I don't know about you but I don't want to be like the other countries of the world; I want to be like the United States of America. We have a good system. Let's stick with it.

If I were a member of this committee and had seen the banking industry come through what it has come through in the last 5 years, I would introduce a resolution commending the system and commending the regulatory bodies that have been involved.

If what I have said is interpreted as flag waving, so be it, I am proud of it. The flag was waved in Massachusetts this week and it was waved in California several months back. Believe me, more and more Americans are going to be waving the flag.

Thank you, Mr. Chairman.

Mr. ST GERMAIN. I thank you, Mr. Johnson.

Now, before we go to the next witness, I would like to get back to Mr. Johnson of the Allied Bank of Texas in Houston, Tex. Now, you stated that—I go back to your testimony and examinations—when you stated you were being examined twice a year by the FDIC, I think you noted I was a little startled because I am a little involved with bank examinations.

Mr. JOHNSON. Let me back up. As I understand it, the FDIC and the State banking department's goal is to examine the banks three times a year every 2 years. Now, at this particular point——

Mr. ST GERMAIN. I asked if your bank was, indeed, examined twice a year by the FDIC and you replied in the affirmative.

Mr. JOHNSON. I misunderstood. We are not examined twice a year by the FDIC, no. Let me reiterate. Their plan is, as my understanding is, to examine the bank three times every 2 years.

Now, at this point we have had two State bank examinations this year. They are there now, as a matter of fact, and they are happy with what they find for that year is record. The FDIC is past due, and we feel that they will certainly be in this year, which will be three examinations we will have this year, and this year the total cost will be probably something over $200,000.

Mr. ST GERMAIN. That is two by the State?

Mr. JOHNSON. And one by——

Mr. ST GERMAIN. And you feel the FDIC will be in?

Mr. JOHNSON. Yes.

Mr. ST GERMAIN. The record shows your bank has been examined once a year, has been examined by the FDIC once in 1974, once in 1975, once in 1976, and once in 1977. FDIC policy is to examine once every 15 months, and it is not statutory, it is a policy.

Mr. JOHNSON. I do not know that.

Mr. ST GERMAIN. And the FDIC examinations, when you talk about costs, that is the cost I would imagine that you are attributing to your personnel operating with the FDIC in the examination, but the FDIC does not charge for its examination.

Mr. JOHNSON. We are talking tangible and intangible costs.

Mr. ST GERMAIN. Does the State charge?

Mr. JOHNSON. We pay a fee for the State. The State runs—I think this examination is costing us about $70,000 one way or another.

Mr. ST GERMAIN. The costs you are talking about—for the most part you are paying that to the State examiners, not FDIC.

Mr. JOHNSON. Right, and by going national we would only have one examination which would be the national examination.

Mr. ST GERMAIN. I just want to put that in perspective.

Mr. JOHNSON. Which would be a big advantage for us to be a part of the national system, because of less disruptions and less costs on examinations alone. The disruptions from my time alone when the examiners are there, both I and my senior officers are in with the examiners discussing loans, and it takes at least 1 week and sometimes more, 8 hours a day just to cover a portfolio.

Mr. ST GERMAIN. Thank you.

I just want to make sure the record is clear on costs of examination, to whom the costs were paid, and frequency of examinations as far as FDIC is concerned.

We in the Congress have no control over the State examiners or the frequency of their examinations.

Mr. JOHNSON. Correct.

Mr. ST GERMAIN. We will now hear from Donald B. Riefler, chairman, sources and uses of funds committee, Morgan Guaranty Trust Co. of New York.

Mr. BROWN. Mr. Chairman?

Mr. ST GERMAIN. Yes, Mr. Brown?

Mr. BROWN. Mr. Chairman, I would like to say a couple of words of introduction that should not come out of his time.

Mr. Riefler is a highly respected member of the financial community. And he follows a very illustrious career of a very illustrious father.

Mr. Riefler's father was Winfield Riefler, assistant to the Chairman of the Federal Reserve Board under Mr. McCabe and Mr. Martin. He has been, without controversy, credited as being the father of FHA, not the controversial FHA of today but the highly commended FHA of that time.

He was a member of Franklin Roosevelt's brain trust, and was the first person ever designated as Economic Adviser to the President.

He was Chairman of the Committee for Economic Warfare during World War II in London, and with all of that, I suppose that some are saying it's highly unusual for a person on this side of the aisle to be so supportive of a person with such strong Democratic credentials. However, Don Riefler is my cousin.

Mr. St Germain. I was just going to say either cousin or uncle. With that introduction, fire away.

STATEMENT OF DONALD B. RIEFLER, CHAIRMAN, SOURCES AND USES OF FUNDS COMMITTEE, MORGAN GUARANTY TRUST CO., NEW YORK, N.Y.

Mr. Riefler. I was worried for a minute that Congressman Brown was not going to mention that the gentleman he was talking about was his uncle, so I am glad to see people can input that from our relationship.

My name is Donald B. Riefler.

I am chairman of the sources and uses of funds committee of Morgan Guaranty Trust Co. of New York. I appreciate this opportunity to comment on your recent legislative initiative to alter the structure of reserve requirements and unbundle Federal Reserve services.

We are pleased that you and your colleagues have recognized in this legislation that the level of reserve requirements presently imposed on member banks of the Federal Reserve System is much higher than is needed for the effective conduct of monetary policy. Present reserve requirements constitute a discriminatory tax on member banks.

In the discussion of the need to reform and reduce reserve requirements, moreover, great emphasis has been placed on actual withdrawals from Federal Reserve membership, perhaps because such withdrawals are highly visible.

My own view is that in the long run a much more significant development stemming from needlessly high reserve ratios has been the erosion in the proportion of total short-term credit that is provided by member banks. The increased use of the commercial paper market to finance the short-term credit needs of large business is a conspicuous example of that erosion.

Although banks provide an efficient and sound mechanism by which to mobilize credit to meet the needs of commerce, industry and agriculture, that efficiency is reduced by unnecessarily high reserve requirements, especially at times when the cost of money generally is high. In these circumstances credit will inevitably seek and find channels around institutions that are required to maintain such reserves.

A second issue dealt with in your bill concerns the services which the Federal Reserve provides to member banks at no explicit charge, in whatever quantity the member banks require and without regard to the costs of producing such services. Although we have some reservations as to the timetable, we are pleased that you have addressed this inefficiency in your bill and have called for the Federal Reserve System to unbundle its operating services.

The bill you have considered addresses important issues and would represent a substantial improvement over the status quo. However, I do have certain reservations concerning the bill. Foremost in our minds is the need for the Federal Reserve to be given clear authority to reduce further the burden of required reserves by paying interest on them.

This is particularly important for reasons of competitive equity in view of the fact that not all depository institutions would be covered by reserve requirements under the bill.

With respect to pricing of Federal Reserve services, the legislation calls for the Federal Reserve to prepare for public comment a proposed schedule of explicit fees for each of the major categories of Federal Reserve services and to set those fees in a manner that includes all the costs that a private commercial enterprise would incur.

This bill, however, does not seem to require the Federal Reserve to do more than to prepare a schedule of fees and pricing principles which it would submit for public comment on July 1, 1979. I am concerned that the bill does not expressly mandate a schedule for implementation of explicit pricing.

One of the issues considered by your committee in the course of its deliberations involves the possibility of requiring reserves against amounts raised by commercial banks in the market for Federal funds. Indeed, the bill as reported now calls for a study by the Federal Reserve on this issue.

Until now the underlying premise of the system of reserve requirements has been that transfers of funds within the banking system should not be subject to reserves.

The obvious logic of this approach is that funds are subject to reserves when deposited initially in the banking system and that it would be double-counting and double-taxation to assess reserves against those funds when they moved from an originating bank to some other bank in the system. We hope that this principle will continue unchanged.

Your committee also considered and called for study of the possibility of imposing reserve requirements on funds raised by commercial banks through repurchase agreements involving U.S. Treasury securities and agency securities. However, I would point out that this would result in a higher cost of financing for the U.S. Treasury, as bank ownership of Government securities became less attractive.

Further, assessment of reserves against repurchase agreements would constitute unfair discrimination against commercial bank dealers inasmuch as nonbank dealers in such securities would not be similarly affected.

In closing, I would like to express my personal view that this is a bill from which the public will realize clear benefits.

First, the unbundling of Federal Reserve services will directly promote greater efficiency in the use of scarce resources. And second, given the sort of competitive banking markets we have, I would expect the reduction of the reserve burden, and therefore of bank costs, to lead to more favorable terms for bank customers.

Thank you, sir.

[Mr. Riefler's prepared statement follows:]

Statement by

Donald B. Riefler

Chairman, Sources and Uses of Funds Committee

Morgan Guaranty Trust Company of New York

before the

Committee On
Banking, Finance And Urban Affairs
House of Representatives

September 22, 1978

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In the discussion of the need to reform and reduce reserve requirements, moreover, great emphasis has been placed on actual withdrawals from Federal Reserve membership, perhaps because such withdrawals are highly visible. My own view is that in the long run a much more significant development stemming from needlessly high reserve ratios has been the erosion in the proportion of total short-term credit that is provided by member banks. The increased use of the commercial paper market to finance the short-term credit needs of large business is a conspicuous example of that erosion. Although banks provide an efficient and sound mechanism by which to mobilize credit to meet the needs of commerce, industry and agriculture, that efficiency is reduced by unnecessarily high reserve requirements, especially at times when the cost of money generally is high. In these circumstances credit will inevitably seek and find channels around institutions that are required to maintain such reserves.

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The bill you have considered addresses important issues and would represent a substantial improvement over the status quo. However, I do have certain reservations concerning the bill. Foremost in our minds is the need for the Federal Reserve to be given clear authority to reduce further the burden of reserves by paying interest on them. This is particularly important for reasons of competitive equity in view of the fact that not all depository institutions would be covered by reserve requirements under the bill.

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Mr. ST GERMAIN. Thank you, Mr. Riefler.

Are there any questions of the witnesses from the members?

Mr. VENTO. Mr. Chairman?

Mr. ST GERMAIN. Mr. Vento?

Mr. VENTO. Mr. Chairman, I don't know if you want to recognize the more senior members first.

Mr. Foster, in terms of assessing what the costs would be with regard to the reservable requirements under this bill for time and demand deposits, did you, in your cost, take into consideration any of the services that would be extended to nonmembers through this bill or did you not?

Mr. FOSTER. No.

Mr. VENTO. I thought not. I think that can make a substantial difference in terms of the type of presentation that was being made.

Mr. Weil, your presentation was interesting. You suggested that increasingly a greater number of banks would be subject to reservable requirements under this proposal.

Are you aware of the indexing proposal that is included in here which sets a specific limit based on the set year as to the amount of reservable requirements that would be covered under this, both in time and demand deposits or not?

Mr. WEIL. I am not sure that the indexing proposal is included in H.R. 14072.

Mr. VENTO. It certainly is. I think we spent considerable time on it as a matter of fact, both Mr. Wylie and myself, and it is included and it, of course, negates the effect that you have presented here, and we hope you will study it more closely and that the effects you have predicted will not occur.

A great deal has been said about correspondent relationships but just as a general statement, in terms of the economy, your statements about jobs were very interesting in terms of the fact it would pull money out of your city, your community, by requiring sterile reserve requirements for the Fed, but the net effect of the bill, of course, is to reduce by $12 billion the reservable requirements on a national basis.

As a consequence, of course, while you may see some redistribution and there may be arguments made on that basis as to having some effect on your community and certainly that is not our intent, we try to be sensitive to that. The net effect of the bill, of course, would be very positive. If you see coming into this bill about $3 billion reservable requirements, $4 billion that are not there now, that produces 800,000 job loss. I suppose we can multiply that three times and point out this bill then, in essence, would create 2.4 million jobs by virtue of the reservable requirements.

I would not do that. It is a very tenuous type of a conclusion. But I want to point out that we did not look at that aspect in great detail. Nevertheless, if we were simply to make the decision on that basis, we would say you are doing very well and ought to, therefore, proceed with due diligence in terms of passage of this bill which substantially reduces reservable requirements for a great many institutions.

Mr. Chairman, I want to ask unanimous consent to enter into the record a telegram that was received earlier from the Northwest Bancorporation. It is a multiple bank holding company and the gist of it is they support the legislation and think it is an improvement to the implementation of monetary policy to help resolve the membership of the Fed System, and rectify competitive inequities among member and nonmember banks.

This is from Richard H. Vaughan, with whom I talked regarding this issue, and I hope that this would become a part of this hearing record as evidence of some support for the legislative proposal which we passed about a week ago.

Mr. St Germain. Is there objection?

The Chair hears none; so ordered.

[The telegram referred to follows:]

[Telegram]

Northwest Bancorporation,
Minneapolis, Minn., September 21, 1978.

Hon. Bruce F. Vento,
Rayburn House Office Building,
Washington, D.C.

Northwest Bancorporation is a multibank holding company headquartered in Minneapolis, Minn., with subsidiary banks serving customers from 83 banks located in 7 upper Midwestern States. Among bank holding companies and banks in the United States it ranks 18th with combined assets of $10.2 billion.

We support H.R. 14072, the Federal Reserve Act Amendments of 1978, and applaud its objectives: To improve the implementation of monetary policy; to help resolve the membership problem of the Federal Reserve System; and to rectify competitive inequalities among member and nonmember banks. We were, however, disappointed that the committee dropped from the bill the provision requiring thrift institutions to maintain reserves on transaction accounts.

This bill would reduce substantially the amount of reserves our banks must carry thus enabling them to put these funds to work in their communities. We are pleased, also, that explicit pricing for services by Federal Reserve banks can give private sector banks a chance to compete in providing services to other banks.

Richard H. Vaughan, *President.*

Mr. St Germain. I believe Mr. Weil wishes to comment.

Mr. Weil. Thank you, Mr. Chairman.

First of all, I would like to say I support wholeheartedly that part of the bill which reduces reserve requirements for all banks. Reserve requirements for banks in the United States have been ridiculously high for too many years.

As a matter of fact, for whatever reason, the Fed has not used the device of changing, altering, reducing reserve requirements as an instrumentality of monetary policy for many years, except in very small degrees.

However, what I was attempting to point out in my testimony is that rather than creating competitive equality in terms of the incidence of the burden of where the additional reserve requirements fall, they fall in a much more difficult and adverse fashion on medium-sized banks in the United States who lend the characteristics of their lending powers and market to smaller and medium-sized business firms.

The effect on jobs is really because of the focus in that market.

The great reduction in reserve requirements, and I certainly would not want to turn this discussion into any big bank, small bank argument, the reduction in reserve requirements goes mostly to large banks. The many billions of dollars of reduction in reserve requirements go to large banks who do not lend the greatest proportion of their lending activity to small business firms.

Mr. VENTO. Mr. Chairman, one of the first words that I learned when I came on this committee is fungibility. And that speaks for itself. It does make money available in the economy. I don't know that you have done an analysis of the banks, and I expect you have not, of the 5,000 banks that are relieved of reservable requirements under this, but I would challenge that, I guess.

Mr. WEIL. The dollars, I am not talking about the number.

Mr. VENTO. No. I am talking about the characteristics of the banks receiving it. There are some necessary reserve requirements reductions for large banks, and for many smaller banks under the criteria set forth in this bill.

So, what I am trying to argue for is, and trying to point out is, that the effect of the reduction is much greater. Total reduction of course is very significant, and would mitigate against the type of testimony you are submitting in terms of stimulus to the economy and in terms of jobs and in terms of business loans and the whole host of services that we look for in commercial banks.

My time has expired. But I expect the chairman would recognize you for further response.

Mr. WEIL. Whatever the implication, I certainly would not want the implication to be that I do not favor very strongly the reduction of reserve requirements. That would be very beneficial.

Mr. VENTO. Thank you for your comments.

Mr. ST GERMAIN. Thank you.

Mr. Derrick?

Mr. DERRICK. Thank you, Mr. Chairman.

I don't have any questions. I would like to make just one or two observations, if I may.

First, I thank each of you; I know you have come at great sacrifice of time and expense to be here this morning. It has been most informative for me.

This is the problem, as I see it, that we are faced with on this particular legislation. Ever since I have really known anything about the banking business, which was a little bit before I came to Congress, I have heard bankers say several things:

One is, we need a strong and independent Federal Reserve System, and I agree with that.

Two is we need to keep politics out of monetary policy, and I agree with that. I think that the only way that we are going to accomplish that over the long run is to keep a strong and independent Federal Reserve System.

I suppose the third observation that I would make is that if there is one industry in this country that needs to know today what is going to happen tomorrow, it is the banking industry. The only way that we are going to have that is to have a strong monetary policy set by the Federal Reserve System, and it is our hope that this legislation will at least go in the direction of accomplishing some of these objectives.

I realize that it probably works some inequities, and maybe that can be worked out in some manner as the legislation moves on.

However, I think not to consider what I have mentioned is taking a short-term view. It may be to the detriment of some banks, but I think the long-term ramifications of this legislation will be to the benefit of the financial community and, as a result, to the benefit of the citizens of this country.

Thank you. I yield back the balance of my time.

Mr. St Germain. Mr. Brown?

Mr. Brown. Thank you, Mr. Chairman.

This legislation, its purpose somewhat oversimplified is, one, the need for greater data and control from the standpoint of the Fed in order for its decision on monetary policy.

The second purpose of the bill, it seems, is to make the Fed System stronger by basically stopping the erosion of membership.

Clearly, the data-reporting requirements of the bill lend themselves to the former, the better development of monetary policy or handling.

When you get to the reserve requirements it is a little bit flaky to determine how that affects monetary policy. But rather basically these provisions are directed to the Fed membership issue so, therefore, those provisions, it seems, should by and large address that question.

But looking at reserve requirements, no one commented upon the elimination of reserve requirements. Now, the State of Illinois has eliminated reserve requirements with respect to State nonmember banks. The State of Ohio, as I understand, is in the process of eliminating reserve requirements.

If you eliminated reserve requirements, how adversely would that impact upon monetary policy or the security of the monetary system otherwise in prevention of failures, or is it more basically an issue of a security for the insurance fund and as that indirectly would impact upon monetary policy? Does anyone care to comment on the issue of just elimination of reserve requirements?

Mr. Derrick. Would the gentleman yield for just a moment?

Mr. Brown. Certainly.

Mr. Derrick. I was talking with a banker earlier this morning, and he made the statement a well-run bank does not need reserves; it is the others that need the reserves.

Mr. Brown. But I don't recall in the State of Illinois they have had a tremendous number of bank failures and they have not had any reserve requirements. Apparently, Ohio is drawing upon that experience and I think it's in the legislature, I am not sure.

Mr. Chambers is not here, but I heard him mention I think it passed one House or something like that to eliminate.

Would anyone care to comment?

Mr. W. W. Johnson. Mr. Chairman, may I comment on Congressman Derrick's observation about a bank not needing any reserves?

Mr. Derrick. That was not my comment. I was repeating something from a banker I was speaking with this morning. I don't know that I necessarily agree.

Mr. W. W. Johnson. Yes, sir. I think we all need reserves, but I think what that bank was saying, we don't need reserves sitting sterile with the Fed. That really does not do my bank, or having reserves of about $25 million, $15 million of which is based on 8/31, sit with the Fed, that does not do anything for me, nothing.

I agree with the gentleman on my right. I have been in the Fed. They really don't offer anything. I mean, you say you can go to the window. I don't want to go to the window. I would rather have that $15 million. It is a sterile reserve, and there is no liquidity in it. I think that is what the banker meant.

Mr. DERRICK. Thank you.

I support the general thrust of this legislation. However, there are things that bother me.

One, it seems to me that the Fed should come in with a specific schedule of pricing, not that we would enact it in legislation, but rather if it comes in with a specific schedule it gives us, they will have to say under what criteria the pricing schedule is adopted and, therefore, we could set forth the criteria for the pricing schedule with flexibility in the Fed.

The second thing that has not been addressed properly is a specific recommendation, a specific outside limits criteria, and so forth, for not having sterile reserves. I won't say payments of interest on reserves, but for at least not having sterile reserves.

Third, I don't think the Fed has justified its position that reserves must be held by the Fed either directly or indirectly, because under the section of this bill that provides for a nonmember bank it can hold its reserves in a correspondent bank, but there must be pass-through to the Fed.

So, for all intents and purposes they are held by the Fed.

Why wouldn't just the establishment of minimum reserve requirements, both as to amount and quality or character, with the holding of those reserves left to State authorities, with respect to a State nonmember bank, why woudn't that work as well to the extent that it impacts on monetary policy. These are the kinds of things, it seems to me, that should be addresed more specifically than they have been addressed in hearings or in this legislation.

Would anybody care to comment? Certainly, Mr. Johnson.

Mr. WALTER JOHNSON. Mr. Chairman, I would like to comment first on your question a while ago about the reserves of State banks.

I am looking at my bank statement as of 9/19. Our reserve requirements on that day, well, let me back up. I don't have that figure. We were keeping $133 million in reserves on that day, which was $64 million more than we needed to keep. So, as a State bank, we are keeping excess reserves every day.

Mr. BROWN. So, you are saying basically that you will protect your institution, whether or not you are mandated to do it.

Mr. WALTER JOHNSON. These are working reserves. I have $133 million in reserves on 9/19/78, which is $64 million that I need to keep. I need to keep 15 percent of demand deposits and 5 percent of time and, again, I am using $64 million. I am twice what I need, but they are working reserves. Under the bill I would have to take $14 million additional idle cash out of my bank and put with the Fed.

This money would still be in reserves, there would be no change in what I have got on 9/19 or today.

I think that many of your bankers are saying that you know if we are going to have to keep idle reserves and it is going to be an additional burden, at least let them be working for the bank and be earning something, because as far as the soundness of the bank is concerned we are keeping those reserves anyway, because they are working balances, they are cash letters in the process of collection, and things like that.

So, really that is not the problem, and the people that I have talked with, I have been talking to a lot of bankers in the last few weeks, and I was in Washington last week and had a long visit with Chairman Reuss and his committee, and the Fed and others.

Since then I have talked to a lot of bankers in Houston and around the country. I don't really find personally a great deal of optimism to the fact that some of us are having to keep reserves and the rest of us are being told to keep reserves and things like that.

The problem is the amount of reserves that are being kept, and that is one big problem. The second problem are those institutions that are being omitted. When we do not include all financial institutions, you are eliminating some 50 percent of the deposits in this country, and I don't think our Congressmen realize the effect that is happening right now, and I am going to give you an example.

One of my customers has been a customer for 18 years of my bank, and we are a small bank by most standards. This customer is a commercial company that maintained $5 million in demand deposits with me for 18 years. About 9 months ago they wrote a check on my bank and deposited it at the Houston First & Savings, which shares our building.

Every day, the customers call my bank to find out what balance they have and make a wire transfer from the savings and loan to the bank. The savings and loan is paying interest on it at 5 percent. We cannot pay interest. We are allowed to pay interest to him on $150,000 only. That is the maximum you can pay interest on demand deposits to any commercial company.

Now that is just one account that I am telling you about and one bank in Houston, Tex. If you look throughout this Nation and find out the amount of deposits that are leaving the banking system and going to other institutions, including your credit unions, your thrifts and savings and loan associations, you are talking about a tremendous amount of deposits.

I visited with Mr. Derrick, Mr. Mattox, and a number of you, when I was here last week. Everybody expressed one grave concern, and I share it with you. I personally feel like we have a strong Fed and I feel like the Fed needs to be very independent.

I do not think we are going to accomplish the objective you are trying to achieve with this bill unless we bring in all of these financial institutions, because, as I mentioned earlier, the things they have been allowed to do have been encroaching more and more on banking, and yet the banks are being asked to come in with more and more controls and try to control the monetary supply, and yet these people have no controls.

They have lower tax rates. The credit unions have no taxes, I understand, and yet we have higher tax rates, and now we have this additional burden, and to me it isn't equitable and won't serve the purpose.

Mr. Brown. Thank you. My time has expired. I would like to indicate to the panel, and the panel that will succeed this panel, that I have a meeting at 11, so I will not be able to be back, not from a lack of interest, but indeed to get a conference with the Senate completed.

Mr. St Germain. I thank the gentleman. I might observe, Mr. Johnson, you talk about the transfers of the deposits that are a thrift institution, and now, using a wire transfer into their account with you, I would just inform you on a few occasions I have attempted to give the banks the authority to pay interest on demand deposits, so called NOW accounts. However, there has been some resistance to that. Anytime you would like, I would be happy to put that bill in again and try to move it again.

At this time, this panel has run over by approximately 35 minutes, and so we are going to take advantage of this vote that is now occurring and switch the panels over. I want to express my deep appreciation to the panel on behalf of Chairman Reuss and all the members of the committee. Some of you might want to make some additional observations as a result of the comments during the question-and-answer period, and you are free and invited, as a matter of fact, to do so for the record.

Thank you, gentlemen, one and all.

The committee will stand in recess for approximately 10 minutes to allow the members to vote, and, upon return, we will hear from the second panel.

[Brief recess.]

Mr. St Germain. The committee will come to order. We want to welcome each and every one of you to the hearing this morning and to this second panel of the morning. We will proceed without further delay.

I might state to each and every one of you that, without objection, we will put your prepared statement in the record, and you may proceed to summarize them, or add further comments, if you wish, as a result of what you heard earlier this morning.

Our first witness at this point will be C. Michael Long, senior vice president, Ranchmart Bank & Trust, Overland Park, Kans.

Mr. Long?

STATEMENT OF C. MICHAEL LONG, SENIOR VICE PRESIDENT, RANCHMART BANK & TRUST, OVERLAND PARK, KANS.

Mr. Long. Mr. Chairman, members of the committee, my name is C. Michael Long, and I am senior vice president of Ranchmart Bank in Overland Park, Kans. I represent a small $50 million nonmember bank, and we are not directly affected by H.R. 14072, as written. My bank is opposed to H.R. 14072 since we feel it could abolish the dual banking system that has successfully served our free enterprise system.

We feel our voice is important for two reasons: First, we will grow in size to a point that we will eventually be required to comply if H.R. 14072 passes, and, second, we feel it is an inroad by the central bank that could destroy the dual banking system. We argue that H.R. 14072 would not give the Federal Reserve better control of the money supply as it proposes to do.

The Federal Reserve now has 5,600 member banks and controls about 72 percent of all deposits. We do not feel that taking in of the remaining nonmembers, comprised of mostly small banks holding the remaining of the 25 percent of deposits, would meaningfully enhance the Fed's control of the money supply.

As a small neighborhood bank, our deposits come from working consumers rather than large commercial depositors. We feel we would have less capacity to service our customer depositors if our reserves were on deposit directly with the Federal Reserve.

As a matter of choice, we were chartered as a State bank in 1966. Our State membership in Kansas contributes to the continuation of our State banking entity. We do not feel that the various 50 State banking departments could continue to stay in business should they have a mass loss of members.

As a State-chartered bank, we reserve through our correspondent bank at Federal Reserve requirements. Where is the justification to have to switch those reserves to nonearning Federal Reserve which will change our capital foundation to a point we would not be able to service our community as well as we have? We respect the central bank, but we do not desire to leave our State charter.

Mr. St Germain. Mr. Long, I just asked staff and unless I am being misinformed, you heard Mr. Vento earlier, your $50 million bank is presently exempt, and you don't feel as though the indexing provision in future years would continue to exempt you?

Mr. Long. I really can't say, Mr. Chairman.

Mr. St Germain. Did you look at the indexing provision in the bill?

Mr Long. I am not that familiar with it, sir.

Mr. St Germain. Unless I am being misinformed by staff, and they are pretty good, they inform me that the odds are that you would not be covered by the legislation. That being the case, would that change your opinion?

Mr. Long. I am sorry, sir?

Mr. St Germain. If that be the case would that change your opinion?

Mr. Long. No.

Mr. St Germain. It would probably diminish the intensity of your opposition.

Thank you, sir.

We will now hear from Michael G. Harper, vice president, Southgate Bank & Trust Co., Prairie Village, Kans.

STATEMENT OF MICHAEL G. HARPER, VICE PRESIDENT, SOUTHGATE BANK & TRUST CO., PRAIRIE VILLAGE, KANS.

Mr. Harper. Thank you, Mr. Chairman, members of the committee. My name is Michael G. Harper, and I am vice president of Southgate Bank & Trust Co. Prairie Village, Kans.

Our bank was chartered in 1956, and at that time we chose to become a State-chartered bank. In the last 22 years we have grown now to the second largest State- chartered bank in Kansas.

It is my contention that H.R. 14072, which is being considered as a means to solve the Federal Reserve Board's membership problem, has been hastily considered, and rather than basically solve the Board's membership problem, it could have a drastic effect on the State segment of the dual banking system. To have a viable dual chartering system, the objectives must remain attractive to banks of all sizes which the present system has offered.

Setting uniform reserve requirements for banks with over $100 million of reservable liabilities is patently discriminatory and would rob large banks of much needed reserves that could be used for job-creating investments. It would also give the Fed excessive control over the Nation's financial activity.

The Federal Reserve Board does not need reserve-setting authority over all State-chartered banks with assets over $100 million as a monetary policy tool.

The Federal Reserve's reserve-setting authority in the past has not been the cause of inflation or the problems with the declining dollar, and these proposed changes will not be a cure.

Present large non-Fed members, who, under the proposal, would have to hold reserves with the Fed, have indicated they will switch to national charters. I am quite sure if this bill does become law, our bank will switch to a national charter.

As an alternative, a reduction in cost of membership and the lowering of reserves for Fed member banks, either across the board or on a selective basis, would basically solve the Fed's membership problems and have no adverse effects on the Fed's monetary objectives. A prerequisite for a strong Federal Reserve membership base is that it be voluntary.

I do not believe this bill is in the public's interest, and is completely unnecessary to achieve the stated objectives. The consequences of enacting such legislation as H.R. 14072 has not been thoroughly studied; and there is no one who can make an intelligent judgment on the impact of this dramatic change in the few weeks remaining before the 95th Congress adjourns.

Thank you.

Mr. St Germain. Thank you, Mr. Harper.

We will now hear from Clair A. Snyder, executive vice president of the American Bank & Trust Co., Reading, Pa.

STATEMENT OF CLAIR A. SNYDER, EXECUTIVE VICE PRESIDENT, AMERICAN BANK & TRUST CO., READING, PA.

Mr. Snyder. Mr. Chairman, I would like to identify our bank. We are located in southern Pennsylvania. We serve the home county of Berks and six adjoining counties. Two of our component banks started business in 1900. We have been a nonmember of the Fed for more than 40 years. We are not a "Johnny-come-lately" in that status.

Twenty-five years ago, we were serving only one county with four branches and deposits of about $100 million, with a net worth of $8 million. Since the early fifties, we have had a strong community objective to build the economic potential of the area we serve. We make loans for the purpose of improving the economic climate of manufacturing and commercial ventures within our trading area. We have attempted to take care of the credit needs, including home ownership of individuals who now number more than 2 million within our seven counties.

By completion of mergers with relatively small banks and starting new banking facilities where needed in that 7-county area, we have grown to a branch banking system of 62 branches. Our deposits have grown to $1,350 million. Our shareholders' equity is now $100,942,000.

We have over 600,000 customers, with an average deposit per customer of $2,000; 160,000 individuals are users of various forms of personal credit.

Partly as a result of our aggressive lending practices, Berks County, which is a standard metropolitan statistical area, has enjoyed one of the lowest ratios of unemployed in Pennsylvania. Several years ago, it had an unemployment ratio which was one of the lowest of all the standard areas of the United States. Five of the other six counties which are in our service area have almost similar records of low unemployment. Schuylkill County has a high unemployment rate due to the drastic decline of employment in the coal mining industry. We have been cooperating with other agencies in that county to alleviate that problem since opening offices there.

We believe the proposed reserve requirements will seriously hamper our bank in committing its assets to the development of its trading area. We estimate that our investment position could be changed approximately $55 million if it does not enter the Federal Reserve System, and more than $10 million if it chooses to become a member. This doesn't account for the additional services provided by correspondent banks and/or the Federal Reserve bank. The reduction in funds available for loan investments would be significant, and a proportionate reduction in both earning assets and real earnings would occur.

Reduction of reserves for large metropolitan banks would probably not stimulate residential mortgage lending or personal credit in the same way. Some additional availability could occur at the smaller banks although real liquidity requirements could offset any real increase in availability.

Our earnings would be adversely affected by the change in its earning assets. This could cause a reduction in its before-tax earnings by as much as 25 percent. This could seriously impact the bank's ability to grow and meet the growing needs of the communities it serves. It could also seriously impact the values of its stockholder's investment and potential future earnings and values.

Because of the substantial impact on the relationships which have developed under the dual banking systems which might completely alter the relative advantages and disadvantages, it could completely destroy the viability of State chartering of financial institutions, and effectively destroy the dual banking system which has proven to be beneficial to our society over an extended period of time.

To the extent that reserve requirements do not apply to large numbers of banks with substantial deposit balances, nor to other financial institutions, this bill shifts any possible influence of reserves on monetary policy to a small number of commercial banks. Failure to include other financial institutions in such a major structural change is inequitable and unrealistic in light of their growing influence in monetary matters.

It may seem to be overly simplified to suggest that a simple reduction in reserve requirements for member banks could produce most of the results which are ostensibly sought by this legislation, but we believe this is, in fact, the case.

At the very least, the drastic effect of this legislation suggests that far more attention must be given to its effect on the whole structure of financial institutions than has been given up to this time. We and other banks are willing to provide any input which will be helpful in understanding this complex problem.

Thank you.

Mr. St Germain. Thank you, Mr. Snyder, for your contribution.

Thomas D. Sayles, Jr., president of the Summit & Elizabeth Trust Co., Summit, N.J.

STATEMENT OF THOMAS D. SAYLES, JR., PRESIDENT, SUMMIT & ELIZABETH TRUST CO., SUMMIT, N.J.

Mr. Sayles. Thank you, Mr. Chairman. As you say, I am from Summit, N.J., with the Summit & Elizabeth Trust Co., and we at our bank jointly appreciate the opportunity to come to talk about H.R. 14072.

We are a modest size bank, $350 million, serving in what we consider as one of the most competitive marketplaces in the country, 25 miles west of New York City, so we are locking horns with the majors as well as savings banks, savings and loans, and many credit unions.

We, as did one prior colleague, had been members of the Federal Reserve. Our bank dates back to 1891. In 1933, we joined the Federal Reserve System, and we were a member for 40 years. In the early 1970's, with great pressure on our earnings and what we could do for our customers and our stockholders, we analyzed Federal Reserve membership. We talked to the New York Federal Reserve people, and the only thing they told us was "patriotism means you should stay as a member." Unfortunately, the cost of the dues were approximately $300,000, which in that year was over 25 percent of our net income, and we felt that that was too high a price to pay, and we reluctantly voted to withdraw from the System.

Since that time, we have grown, and our earnings have improved, and we think that the decision at that time was a proper choice. We do think that the freedom of choice is certainly the cornerstone of our financial structure, and it has been a very successful one in this whole country, and we hate to see any tampering with it.

When we withdrew from the System in early 1973, we were a $200 million bank and had about $22 million in our cash and due-from-banks accounts. We have now grown to about $350 million and still have a similar amount of funds in this sterile account, around $22 million.

What have we done with the extra? We basically, as some of my associates have said earlier today, put it into mortgages. Our mortgage account has grown from $50 million to $100 million, and we have assisted our community in keeping viable and helping businesses be productive and profitable.

Mr. St Germain. When you mention the mortgage, do you have a breakdown as to commercial, business type, as against residential, included in your presentation?

Mr. Sayles. Yes; we do. We are over 50 percent in residential. Well over 50.

Our bank charter obligates us to be involved corporate citizens, both with people and dollars. We serve our communities in charitable, civic, and social agency groups. A reduction in profitability would obviously lessen our ability to be involved in these worthy causes.

We view this bill as being unfair discrimination against our 2,000 stockholders and approximately 70,000 depositors. We feel this is a type of bill that has to be spread, if it is going to be introduced as presently constituted, to all financial institutions, savings and loans, savings and smaller banks who will have no deposits at all required in reserves.

Many people much more knowledgeable than I have questioned that reserve membership is actually important to the effectiveness of monetary policy.

I would like to quote briefly from George LeMaistre's testimony. He was the former Chairman of the Federal Deposit Insurance Corporation, and, on August 4, this year, he said, "All of those economists that I am familiar with have concluded that increased Federal Reserve membership is not important to the effectiveness of monetary policy." He cites a number of erudite studies to support his conclusion.

Quite obviously, H.R. 14072 tips the scale heavily in favor of national banking as opposed to State system. Both at this time appear to be quite healthy, and we think this is a very good sign and we shouldn't change it.

Not surprisingly, New Jersey's commissioner of banking, Angelo Bianchi, is strongly opposed to the legislation. I seem to recall that the matter of member banks receiving interest on their reserves was discussed in some detail by this committee. What happened to that concept?

Failure to pay such interest is tantamount to the imposition of a tax without calling it that—clearly taxation without representation.

Explicit pricing of services is another matter which the Federal Reserve will have to come to a conclusion on by July 1 next year. If some financial return earned on the billions presently maintained as reserve requirements is not proposed, it will be a serious and unfair thing. We are already competing with thrifts who have much more favorable rules, regulation Q differential, taxation on a different basis, lower reserve requirements, plus they have an enthusiastic advocate in the Federal Home Loan Bank Board as their regulator.

In conclusion, I would urgently request that the committee consider further impacts which H.R. 14072 will have on the banking industry in general, and the middle-size nonmember banks, in particular. Payment of interest on required reserves, or allowing short-term Government securities to be counted as part of a bank's reserves, along with the explicit pricing system of the Fed are entirely proper solutions, and fair consideration should be given to these alternatives. The dual banking system is a proven quantity; let's not destroy it.

I would like to also respond to two comments that Representatives made before the first panel. Representative Brown indicated that he wondered why we couldn't use Government securities as part of reserve requirements, and we think that certainly is appropriate. However, it would be politically unpalatable as the loss of earnings from the Federal Reserve System would be dramatic.

Thank you.

[Mr. Sayles' prepared statement follows:]

The Summit Bancorporation
P. O. Box 381, Summit, New Jersey 07901 (201) 277-6200

THOMAS D. SAYLES, JR.
PRESIDENT

Mr. Chairman, Committee members, I am Thomas D. Sayles, Jr., Chairman and President of the Summit and Elizabeth Trust Company, Summit, NJ. I appreciate your providing me the opportunity to comment upon H.R. 14072, as it will have a very deleterious and, I believe, unfair affect on our institution.

We are a modest size ($350MM) bank competing in what I perceive as being the most competitive financial marketplace in this country. Summit is located approximately 25 miles west of New York City - in Union County, a mature, fully developed suburban area, with many New York City commuters. We also have branches in Elizabeth, NJ an old city of 100,000 population adjacent to Newark Airport and an industrialized city with all the attendant problems of such a Northeast urban city.

Summit and Elizabeth Trust dates back to 1891 and voluntarily joined the Federal Reserve System in 1933. During the early 1970's it became apparent to us that the cost of membership was becoming burdensome and, when certain changes in Regulation J were enacted, thereby drastically reducing float, our Board of Directors felt obliged to ask management to make a full study of the alternatives. Our investigation lasted several months and included sessions with representatives from the New York Federal Reserve Bank. We found that the services provided by the latter could be obtained from the large New York commercial banks, whose charges could be offset by balances, so-called compensating balances. These same balances would also be counted as part of our required reserves. It was determined that the membership "dues" worked out to be over $300M or well over 20% of our then total pre-tax income. Our Board felt that this was too stiff a price to impose on our stockholders and customers and, since officials at the central bank could offer no immediate hope for relief, reluctantly voted unanimously to request permission to withdraw from the System.

At that time we thought the rules should be equal for all, and we continue to feel the same way. We also feel strongly that the dual banking system and all that it entails is a healthy one and has served our country very well during the past century. Freedom of choice is truly the cornerstone of our entire economic system and tampering with it can only have dire consequences.

A look at NJ's present reserve requirements may be worthwhile in putting this subject in perspective. Non-member commercial banks must keep from 15 to 30% reserves against their demand deposits and 3-6% against savings and time deposits, but no more than the current Federal Reserve stated reserve requirement. Hence at this time we have a 12 3/4% rate for checking accounts and 3% for time deposits or approximately $17MM.

The direct consequence of H.R. 14072 upon Summit and Elizabeth Trust Company is quite revealing, i.e. the sterilization of approximately $9MM with no apparent benefit to our Bank. At December 31, 1972 we were a $200MM member bank with a Cash and Due from Banks account of $22MM, at December 31, 1977, we were a $328MM non-member institution with the same size Cash and Due from Banks account. What did we do with these liberated funds, primarily they went into mortgages, the portfolio growing 100%, from $50 to $100 million. These mortgages have been to NJ residents and businesses, assisting in keeping our communities viable and providing many jobs.

The reserves under H.R. 14072 which will be mandated to be maintained at a Federal Reserve Bank will have a serious affect on our net income and adversely affect our service to our communities which I will go into later. Since not all factors are known at this time (The Fed. Reserve explicit pricing system in an unstated quantity, for example), we can only make some rough calculations. The results are not encouraging though - a possible 15-20% drop in pre-tax income, a most significant event, which I believe you would not deny.

We may flatter ourselves, but we look upon our bank as a progressive bank which fully understands that having a bank charter obligates us to be involved, corporate citizens in both our State and those communities we serve. We provide both people and money (approximatley 1% of pre-tax income) to a wide variety of charitable, civic and social agency groups. A reduction in profitability will obviously cause a lessening of our involvement with these worthy causes.

NJ introduced a Economic Development Authority several years ago and our bank has been a leading participant. This program which allows tax-exempt bonds to be issued and purchased when new jobs are being created has had a very positive affect on our State. Only banks which have taxable income find participation in this program to be worthwhile. A cutback in this area and a reduction in our purchases of local municipal bonds would also be detrimental to our economy.

We view this bill as unfair discrimination against our approximate 70,000 depositors and 2,000 stockholders, both groups which we believe we have served well. Our marketplace is presently served by major New York City banks, large Newark based banks, commercial banks of our size, along with many banks with under $100MM in deposits and lastly, a wide variety of thrift institutions. As I understand the proposed Bill, commercial banks with under $100MM in deposits will not have any required reserves, thus providing them with a distinct advantage in competing with us. The so-called thrifts, i.e. savings and loan associations and savings banks, already enjoy preferential treatment in the form of lower reserves and, we really question the wisdom and fairness of maintaining or adding to this inequality.

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The stated purpose of proposing legislation in this area was, as I understand it, to stem the attrition of membership in Federal Reserve System which in turn was purportedly having an adverse affect on the precision with which monetary policy could be conducted. If this is truly the area of concern, why not involve all financial institutions such as the fast growing credit unions, savings and loan associations and saving banks.

Many people much more knowledgeable than I have questioned that Reserve membership is actually important to the effectiveness of monetary policy. Quoting George Le Maistre's, former Chairman of Federal Deposit Insurance Corp. statement dated 8/4/78 "All of those (economists) that I am familiar with have concluded that increased Federal Reserve membership is not important to the effectiveness of monetary policy." He cites a number of erudite studies to support this conclusion. He also notes the minimal use of changes in reserve requirements in recent years and cites its apparent limited impact.

The imposition of H.R. 14072 would quite clearly tip the scale heavily in favor of national banking as opposed to State systems. Both appear healthy at this time, to have contributed to the world's most innovative, responsive and free financial system. Let's not tinker with a winner. Not surprisingly, NJ's Commissioner of Banking, Angelo Bianchi is strongly opposed to this legislation.

I seem to recall that the matter of member banks receiving interest on their reserves was discussed by this Committee in detail. What happened to that concept? Failure to pay such interest is tantamount to the imposition of a tax without calling it that - clearly, taxation without representation. The present system is wrong, please do not compound it.

Explicit pricing of services provided by the Federal Reserve Banks can surely only be considered if some financial return is earned on the billions presently and in the future to be maintained as required reserves. The present proposal seems to be patently unfair and a burden on a particular segment of this nation's banks.

We expect to pay our fair share of the inherent costs of our great financial system, however, we do not want to pay for someone else's share. We already are competing with the thrifts which have more favorable rules, i.e. Regulation Q differential, taxation on a different basis, lower reserve requirement, plus having an enthusiastic advocate in the Federal Home Loan Bank Board as their regulator.

It also appears that the initial level of $50MM demand deposits and $50MM savings deposits which are exempt from reserves could quite conceivably be lowered, as might also the reserve ratio be altered from the proposed 7%, thereby adversely affecting a greater number of banks.

In conclusion, I would urgently request that the Committee consider further the impact which H.R. 14072 will have on the banking industry in general and the middle size non-member banks in particular. Payment of interest on required reserves, allowing short-term government securities to be counted as part of a bank's reserves along with explicit pricing of Federal Reserve Bank services are entirely proper solutions and fair consideration should be given these alternatives. The dual banking system is a proven quantity, don't destroy it.

Thank you.

9/21/78

Mr. St Germain. Thank you, Mr. Sayles.

We will now hear from Harry H. Nye, executive vice president, Franklin State Bank, Somerset, N.J.

STATEMENT OF HARRY H. NYE, EXECUTIVE VICE PRESIDENT, FRANKLIN STATE BANK, SOMERSET, N.J.

Mr. Nye. Thank you, sir. Mr. Chairman, members of the committee, I appreciate this opportunity to speak before you. My bank is a $410 million bank, obviously a State nonmember bank, located in central New Jersey. At your request, I will attempt to highlight my comments in my written statement.

As I think about this bill and think about the issue before us, it seems to me that the real critical issue here is bank earnings. It is really the reason that we have seen banks leaving the Federal Reserve System. Obviously these earnings are most important to the banking system. I guess the most critical problem we face today is our ability to increase and to attract capital.

This problem of earnings has been further complicated by a number of issues that face us today. These issues face all industries to some degree, that being inflated cost, mandated increased costs, such as imcreased social security. But in addition to that, the banking system has been faced with a number of issues that are really going to increase their costs of operation.

On November 1, by regulation of the Federal Reserve and of the FDIC, we will undoubtedly be faced with more and more of our deposits becoming time deposits as a result of the regulation passed by those bodies which will allow our customers to maintain their balance as time deposits and transfer only to cover overdrafts.

Obviously the mandated cost of services that the Federal Reserve System will have will be passed along throughout the banking system so that this will be one other increased cost to us.

The approval of interest on Treasury tax loan accounts has taken place, but as yet has not been implemented, but again we face this as an additional cost of doing business.

All this, along with the fact that our share of the deposits in the so-called banking system are declining because of the unfair competition we face with the thrift industries, we are seeing a higher percentage of the deposits move into the savings banks and savings and loans, and thus gives us less of an opportunity to invest funds and earn upon these funds.

I share the concern of others that this law will do two basic things. It will undoubtedly harm the dual banking system, which, as many have mentioned, has been in existence for some 200 years. I think it will drive both large and small institutions into the Federal Reserve System. In so doing, I think it will also adversely affect correspondent banking systems, which has been built up over an equal period of time, and because the banks will no longer have the excess funds to maintain their correspondent banks, many of these services will no longer exist.

We, in particular, of course, are concerned about the effect this will have on our earnings. As others have stated, the effect will be approximately 21 percent at a bottom line after-tax earnings. We earned some $2.1 million in 1977; the effect would be a decrease of about $450,000 in this net income.

We are not particularly proud of our level of earnings we have had over the years, but it has been due, to a great degree, to the fact that we are a community-oriented bank. We have tried to provide many community services. I repeat what one of the other banks mentioned; of a $400 million bank, we have in excess of $8 million in student loans. If we are faced with this earnings crunch, we will no longer be able to continue offering these at least to the degree we have in the past.

We have also serviced many minority groups and development-type groups in granting low-rate-interest loans. Again, this type of thing will have to be a thing of the past.

We feel that these earnings are important to the banking system in order, as I have said, to keep capital in our system and be able to attract new capital. If we do not have these earnings, we are no longer going to be able to give the service to our communities, and provide the lending required to have our country grow as it should. I really think that the price that we are paying in the harm to the dual banking system, to the correspondent banking system, and to the earnings of the bank, particularly in our size range, are too great, and that this bill should be reconsidered.

[Mr. Nye's prepared statement follows:]

Testimony presented to the House Banking, Finance and Urban Affairs Committee on September 22, 1978 concerning H.R. Bill 14072, The Federal Reserve Act Amendments of 1978

By: Harry H. Nye
Executive Vice President and Treasurer
Franklin State Bank
Somerset, New Jersey

I represent Franklin State Bank, Somerset, New Jersey, a nonmember bank, chartered by the State of New Jersey and insured by the Federal Deposit Insurance Corporation with total resources of approximately $410,000,000.

Speaking on behalf of the Bank I represent, and I believe echoing the feelings of most nonmember banks with deposits in excess of $100,000,000, I would urge that H.R. Bill 14072 not be recommended for passage for the following reasons:

1. This proposed law would have an adverse effect on the future of the dual banking system, forcing banks of all sizes to join the Federal Reserve System.

2. The significant effect that proposed law would have on the earning power of banks, particularly nonmember banks with deposits in excess of $100,000,000 and banks with a high percentage of savings deposits.

3. The further adverse effect lower earnings will have upon the ability of banks to retain and attract equity capital to sustain the financial growth of our country.

4. The problem of this impact upon bank earnings, coupled with other actions and proposed actions that are going to further impact earnings, includ- the following:

   (1) The change in federal regulations as of November 1, 1978 permitting automatic transfers from savings accounts to cover checking account overdrafts.

   (2) Proposed charges by the Federal Reserve System for services, that will be passed along throughout the banking system.

   (3) Interest payments that will be paid on Treasury Tax and Loan Accounts.

   (4) Continuing decline in the percentage of total deposits held by commercial banks, primarily as a result of the interest differentials permitted between thrift institutions and commercial banks.

5. This proposed law would further give the Federal Reserve System additional competitive advantages over correspondent banks and because of the movement of balances to Federal Reserve Banks could seriously affect the ongoing viability of the correspondent banking system.

6. This action does not appear necessary to allow the Federal Reserve System to control monetary policy, with most of this control coming from the activities of the Open Market Committee.

Specifically, I would like to support our reasons in opposition to this Bill as follows:

1. Effect upon the Dual Banking System:

The future of the dual banking system would undoubtedly be greatly affected by this proposed law. Both large and small banks would feel "forced" into the Federal Reserve System and many would apply for National charters to avoid supervision by several agencies. Small banks (less than $100,000,000 in deposits) will flock to the Federal Reserve System to avoid Reserve requirements. This raises the further question of the supervision of "Liquidity" in these smaller banks.

Larger nonmember banks will be motivated into the Federal Reserve System because they will no longer be able to afford to maintain balances with correspondent banks to cover the cost of clearing checks and other services rendered, and still maintain the necessary reserve requirements with the Federal Reserve System.

2. Adverse Effect Upon Bank Earnings:

Basically, the requirement for the maintenance of reserves with the Federal Reserve System will require our bank to maintain an additional $9,700,000 in uninvested cash and would adversely affect our after-tax earnings by almost $450,000, more than 21% of the net income of our bank for the year 1977. Exhibit A is attached, detailing the reserve calculations and the impact on earnings.

With this impact on our earnings, we would have to review more closely, certain phases of our operations, including:

(1) Volume of student loans

(2) Loans to minority and development groups at lower interest rates

(3) Employment levels within our bank

3. Effect upon Capital Accumulation:

The most important challenge facing the banking industry and the financial world today is the ability to raise capital to finance the growth of our nation. The ability to earn a sufficient return on capital is the most important ingredient in increasing capital, both in terms of retaining earnings in the business and in providing sufficient earnings to attract new capital investments. As the banking industry faces more and more pressure on their ability to earn, the problem of capital accumulation becomes even more acute

4. Other Adverse Effects upon Bank Earnings:

At no other time in history has the banking industry been faced with actions and proposed actions that will seriously affect their ability to generate sufficient earnings to maintain the safety of our banking institutions and provide the ability to attract new capital.

The approved regulations by the Federal Reserve and FDIC to allow customers to maintain their balances in savings accounts and automatically transfer funds to their checking accounts to cover overdrafts is expected to increase significantly the cost of funds to the banking industry.

The proposed charges for services by the Federal Reserve would increase operating expenses throughout the banking system, since these costs will have to be absorbed throughout the banking system.

Interest payments on Treasury Tax and Loan accounts, which is expected to be a reality in the very near future, is still another expense burden that must be assumed by commercial banks.

With all of these new costs facing us, the commercial banking industry still has the ongoing problem of attracting and maintaining their deposit base, while continuing to compete with the thrift industry that continues to have the advantage of interest rates on retail time deposits as provided under Regualtion Q. Exhibits B. C. D. & E. attached, illustrate the trends in total market share between commercial banks and thrift institutions in the State of New Jersey from 1960 to 1977.

5. Effect upon the Correspondent Banking System:

I feel that this bill pending before your committee, will have a very serious impact upon the future of the correspondent banking system that has worked very successfully in this country going back to the days when individual banks issued their own currency. As previously stated, the very nature of this bill is going to force banks, both large and small, into the Federal Reserve System. With the requirement that reserve balances be maintained at the Fed and with the expected requirement that explicit fees be paid for all services rendered by the Fed, banks will no longer be able to afford the "luxury" of maintaining significant balances with their correspondent banks. State nommember banks have always provided a significant portion of the correspondent banking business handled by the larger banks.

6. Federal Reserve Control of Monetary Policy:

As detailed in this pending Bill, the Federal Reserve

System has the ability to access the necessary information to monitor the movement in monetary aggregates without requiring that reserves be maintained with the Federal Reserve Banks. Basically, I believe that the Federal Reserve's primary tool for controlling monetary policy lies with the actions of the Fed's Open Market Committee. The control of the level of reserves plays a relatively small part in the overall program.

In conclusion, I would submit that the impact this proposed law would have upon the earnings of the nonmember banks with deposits over $100,000,000, the impact upon the dual banking system and upon the correspondent banking system in our country is not necessary to provide the controls needed by the Federal Reserve System to monitor and control the monetary policy in our country.

Exhibit A - Reserve Calculations as per HR 14072 - Franklin State Bank
Somerset, New Jersey (In Thousands)

				Required Reserve
Average Demand Deposits		$120,000		
Less: Average Items in the process of collection	$13,200			
Average Due from Banks	5.950	19,150		
Average Net Demand Deposits		100,850		
Average Savings Accounts		85,000		
		185,850		
Less Exemption		50,000		
Deposits subject to Reserves		$135,850	@ 7%	$ 9,509
Average Time Deposits with Maturities less than 180 days		101,000		
Less Pro-rata Exemption		33,000		
Deposits subject to Reserves		68,000	@ 6%	4,080
Average Time Deposits with Maturities over 180 days		$ 52,000		
Less Pro-rata Exemption		17,000		
Deposits subject to Reserves		$ 35,000	@ 1%	350
Total Required Reserves				$13,939
Less Average Vault Cash				4,250
Total Net Required Reserves				$ 9,689
Reduction in Annual Earnings based on Average yield on earning assets (8.85%)		$857		$
Reduction in Federal Income Taxes		411		
Reduction in Annual Net Income		$446 *		

*Based on net income of $2,102,000 for 1977, this would represent a reduction of 21.2% in net income.

EXHIBIT B

NEW JERSEY

*SAVINGS MARKET SHARES (In millions)

	1960		1974		1976		1977	
	$	%	$	%	$	%	$	%
Commercial Banks	3,628.0	46.2	12,653.0	45.7	14,500.0	41.9	15,291.0	40.0
Savings Banks	1,347.2	17.2	4,674.1	16.9	6,100.0	17.6	6,843.0	18.0
Savings & Loans	2,769.0	35.3	9,956.6	35.9	13,400.0	38.7	15,332.0	40.1
Credit Unions	105.0	1.3	431.3	1.5	613.0	1.8	739.0	1.9
TOTALS	7,849.2		27,715.0		34,613.0		38,205.0	

*Dollar amount and percentage of time deposits in each type of institution

SOURCES: New Jersey Department of Banking
Office of the Comptroller of the Currency
Federal Home Loan Bank Board
National Credit Union Administration

EXHIBIT C

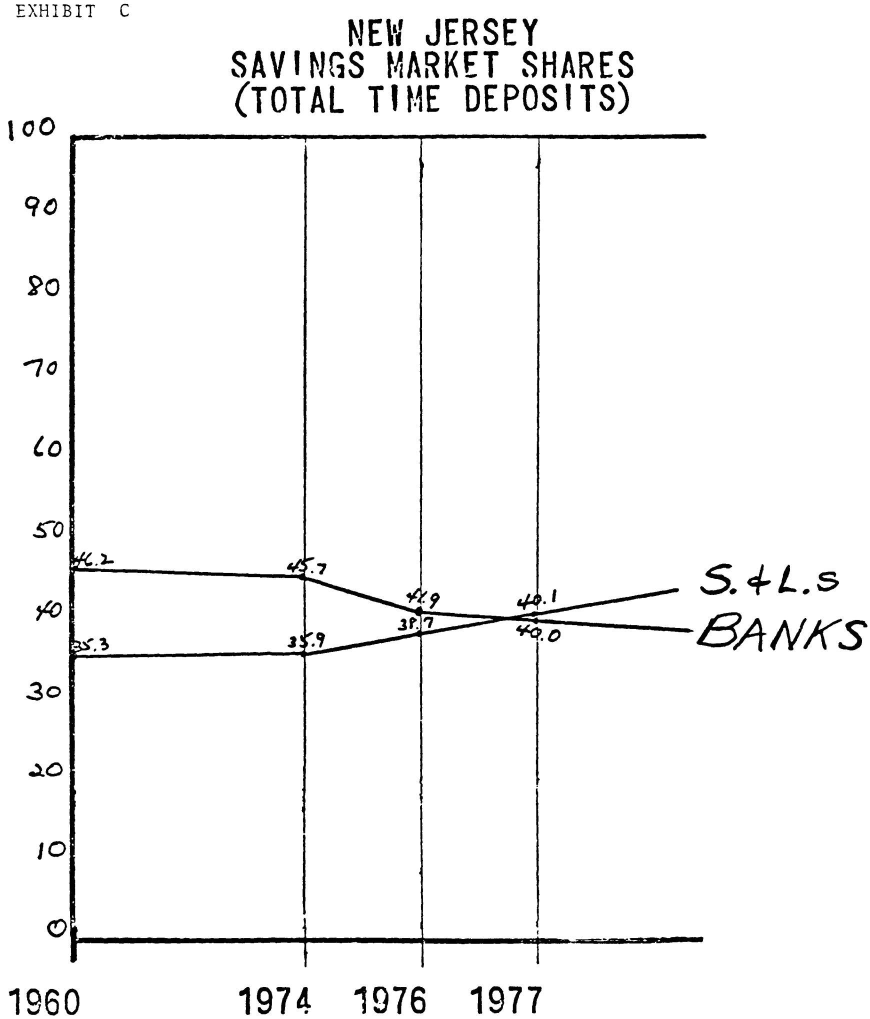

NEW JERSEY
SAVINGS MARKET SHARES
(TOTAL TIME DEPOSITS)
100
90
80
70
60
50
40
30
20
10
0
46.2
45.7
41.9
40.1
35.3
35.9
38.7
40.0
S.&L.s
BANKS
1960
1974
1976
1977

EXHIBIT D

NEW JERSEY FINANCIAL INSTITUTIONS

TOTAL DEPOSITS

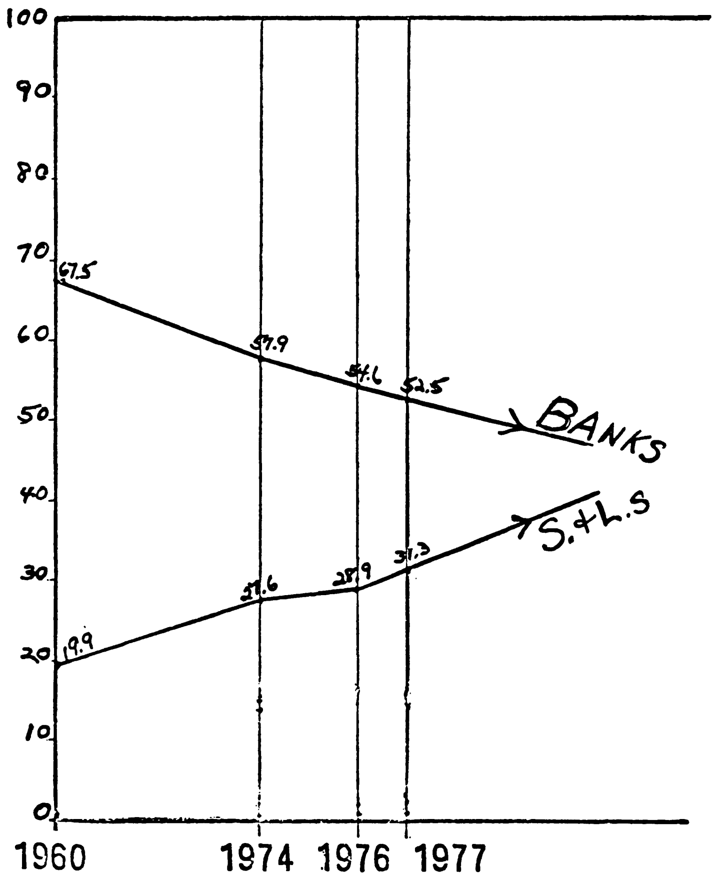
IN MILLIONS OF DOLLARS
(At Year-End)

	1960		1974		1976		1977	
	$	%	$	%	$	%	$	%
Commercial Banks	7,219.0	67.5	20,904.0	57.9	23,363	54.6	25,709	52.5
Savings Banks	1,347.2	12.6	4,818.1	13.3	6,386	14.9	7,226	14.7
Savings & Loans	2,127.8	19.9	9,956.6	27.6	12,392	28.9	15,332	31.3
Credit Unions	not available		431.3	1.2	613	1.4	739	1.5
TOTALS	10694.0	100%	36100.0	100%	42,754	99.8%	49,006	100%

SOURCES: New Jersey Department of Banking
Office of the Comptroller of the Currency
Federal Home Loan Bank Board
National Credit Union Administration

EXHIBIT E

SHARE OF TOTAL DEPOSITS OF FINANCIAL INSTITUTIONS IN NEW JERSEY 1960 - 1977



The CHAIRMAN. Thank you very much, Mr. Nye.

We now turn to a number of distinguished bankers from Arizona, and with no particular order other than the way you are seated, we will call on Rex E. Staley, president of the City Bank of Sun City, Ariz.

STATEMENT OF REX E. STALEY, PRESIDENT OF THE CITY BANK OF SUN CITY, ARIZ.

Mr. STALEY. Thank you very much, Mr. Chairman. We appreciate the privilege of being here today to testify before your august committee.

As you have said, my name is Rex Staley. I am president of City Bank in Sun City, Ariz. We are a State-chartered, nonmember bank of the Federal Reserve System. We are a unit bank, one office, and our total assets are a little more than $21 million. Our deposits are approximately $19,500,000. We are an "exempt" bank. I am the founder of the bank, which is only 6 years old, and have been chief executive officer of several commercial banks and a savings and loan association in the Phoenix area during the past 33 years.

The proposed legislation, according to the title on the bill I received, was introduced "to facilitate the implementation of monetary policy and to promote competitive equality among commercial banks." So, therefore, we are an exempt bank. I did not find in this bill that it positively addressed the implementation of monetary policy, nor did I find that it established competitive equality among banks unless one were to accept the fact that it penalizes banks which will be required to maintain reserves and forces them into a less favorable loan position. Monetary policy, according to Chairman G. Willian Miller, is not formulated, nor is it implemented, by bank reserves. Therefore, the purpose, as stated, is not achieved by the provisions of the proposed legislation.

The proposed legislation imperils the dual banking system. It is imperative that the dual banking system be maintained in order to insure the financial health of the Nation; and, just as importantly, to prevent the nationalization of the banking industry. "Exempt" banks, of which there are a great many, would become members without reserves, thereby weakening the banking departments of the various States and destroying the correspondent banking system.

Although the deposit limits are established at given figures in this proposed legislation, in my opinion the numbers are subject to change by future governmental bodies. As a representative of a small "exempt" bank, I see this as "the camel's nose under the tent."

The future could bring a lowering of deposit limits on a repetitious schedule until all banks would be required to maintain reserves at the Federal Reserve. Everything is subject to change, and the same body that establishes "exempt" status today for a class of banks can, by the same token, extinguish that class tomorrow or next year.

Finally, if the Federal Reserve wishes to stem the tide of membership defection, the present law permits the lowering of reserve requirements. Perhaps this course of action deserves consideration and implementation prior to the adoption of any proposed legislation, particularly as it does not appear to serve the national interest in any regard.

[The following letter enclosing a copy of a resolution unanimously adopted by the Arizona Bankers Association on September 18, 1978, regarding H.R. 14072, was submitted by Mr. Staley for inclusion in the record:]

ARIZONA BANKERS ASSOCIATION

1104 ARIZONA TITLE BUILDING • PHOENIX, ARIZONA 85003 • PHONE (602) 252-6136

September 18, 1978

To: Presidents, All Member Banks
Arizona Delegation to Congress

Subject: Arizona Bankers Association Resolution Regarding Federal Reserve Act Amendments of 1978. H.R. 14072.

Enclosed is a copy of a resolution unaminously adopted by the Arizona Bankers Association on September 18, 1978 regarding Federal Reserve Act Amendments of 1978, H.R. 14072. We hope this document will be helpful in your future deliberations on the subject.

Rex E. Staley
Rex E. Staley, President
Arizona Bankers Association

September 18, 1978

ARIZONA BANKERS ASSOCIATION

RESOLUTION

The Arizona Bankers Association is in sympathy with the member banks of the Federal Reserve and the membership problems presently being encountered by the Federal Reserve. It is the Association's position that relief should be given to member banks in the form of reduction of reserves and/or payment of interest, and implicit pricing of Federal Reserve services. Recently, legislation has been introduced in the House of Representatives requiring non-member state banks with deposits in excess of $50MM demand and savings and $50MM time to establish reserves with the Federal Reserve on a non-interest basis. Although hearings have been held in Congress with regard to the problems with the Federal Reserve membership, the implications of the shift in philosophy to mandating a certain level of captive Fed reserves are very serious. There is no way anyone can make intelligent judgements on the impact of this dramatic change in the few weeks remaining before the 95th Congress adjourns. Failure to intelligently absorb these implications prior to passage of legislation causing such sweeping change in our banking system would be a serious mistake.

1. The reduction in costs of membership could also be realized if the Fed would simply reduce reserves for member banks up to the limits acceptable to the Congress.

2. The income gain from freeing up reserves cannot yet be netted against the cost of explicit pricing of Fed Services because the Fed's pricing program is still being formulated.

3. Once reserves are mandated for all large banks and the "membership problem" is resolved, reserve ranges could always be restored or altered which eventually could mandate reserves for all banks, large or small.

4. The bills are politically motivated and structured and are aimed at dividing the industry on large versus small grounds.

5. Damage to the viability of the dual banking system will be massive. Present large non-Fed members who now will have to hold reserves with the Fed reveal they will switch to national charters. In some states, this would seriously cripple the state departments of banking.

6. If the states react, in time, to the relief offered all banks under a certain size from <u>any</u> reserve requirement and offer the same exemptions, the shift in balances now held at correspondent banks will be very significant.

7. Evaluation of the impact of the new costs to a correspondent bank and to its respondent banks is impossible. The change could have sizeable long-range negative profit implications, depending on the future program of pricing of Fed services and the imposition of reserves on repurchase agreements and Fed funds.

8. The consequences of these bills for the effectiveness of monetary policy have not even been studied. It seems clear, though, that more of the direct burden of monetary restraint will be shifted to a fewer number of banks.

9. Competitive, non-bank depository institutions will not be covered by the bills. The opportunity will probably be lost forever to responsibly deal with this gross inequity.

In view of the above circumstances, and the fact that continuation of the dual banking system would be seriously imperiled, it is our Association's position that this legislation not be enacted and be vigorously opposed by the members of the Arizona Congressional Delegation.

American Bank of Commerce	Rowland Prestwick, President
The Arizona Bank	Robert L. Matthews, President
Bank of Northern Arizona	George Tyson, President
The Bank of Scottsdale	Neil Manahan, President
Citizens Union Bank	James E. Barry, President
City Bank	Rex E. Staley, President
Community Bank of Wickenburg	Gary E. Johnson, President
Continental Bank	Robert F. Stone, President
Copper State Bank	Robert DeBow, Chairman
First American National Bank	Robert A. Melcher, President
First National Bank of Arizona	Edward M. Carson, President
Great Western Bank and Trust	John Cotton, President
Mission Bank	Bill Abel, President
Southwestern Bank	George A. Weismann, President
The State Bank	Robert I. Rasmussen, President
Thunderbird Bank	Robert W. McGee, President
Union Bank	George L. Clark, President
United Bank of Arizona	Morton L. Monson, President
Valley National Bank	Roger A. Lyon, President

The CHAIRMAN. Thank you.

Howard C. McCrady, senior vice president of the Valley National Bank of Phoenix, Ariz.

STATEMENT OF HOWARD C. McCRADY, SENIOR VICE PRESIDENT OF THE VALLEY NATIONAL BANK OF PHOENIX, ARIZ.

Mr. McCRADY. Thank you, Mr. Chairman. My name is Howard C. McCrady. I am senior vice president and chief financial officer of the Valley National Bank of Arizona. We are not a holding company. We are a national bank and therefore a member of the Federal Reserve System. We have 180 branches serving the State of Arizona, and our total assets are approximately $4 billion. Our deposits are approximately $3.4 billion. Our bank, approximately 80 years old, is the largest bank in Arizona, the largest bank in the Rocky Mountain region, and the 26th largest in the United States, and employs 6,000 people. The proposed legislation has several factors in it that we believe at least need further careful study before a bill with such sweeping impact is passed. In fact, this need is recognized in the bill, and we suggest all of the studies be done before the legislation is passed.

The committee's bill airses from Chairman Miller's desire to stem the decline in Federal Reserve membership on the theory that such decline was reducing the Fed's ability to exercise its monetary control responsibilities. We understand member banks represent 73 percent of deposits in the banking system, down from 80 percent at the end of 1970. Chairman Miller originally proposed that the Fed could resolve this membership problem by paying interest on reserves and charging for its services. If both interest and charges were to be competitively oriented, we would be supportive of such a bill.

But the resolution of the membership problem has taken a totally different turn by singling out about 1,100 banks out of approximately 14,000 banks to shoulder the full costs of being instruments of Federal Reserve monetary control—and, contrary to the Chairman's original objective of reversing the trend, these banks apparently would only represent 68 percent of the Nation's deposits. Indeed, the entire structure of the U.S. banking system is being impacted by this legislation, and we, for one, do not feel that the full implications of the legislation have been adequately analyzed or developed.

It is true that the impact of this legislation would be to reduce our reserve requirements. However, until we see the schedule for pricing from the Federal Reserve System for its services, we cannot fully assess the impact of this legislation on our bottom line. These prices should be set before the legislation is passed.

More specifically, we do not believe that savings deposits should carry the same reserve requirement as demand deposits. Savings are less volatile funds and therefore should carry a lower reserve requirement. We do not believe that the new transfer account will significantly increase the volatility of savings deposits. In fact, surveys we have done indicate that many people do not want to have easy access to the "rainy day" money that they keep in savings accounts.

We further believe that large money center banks would be the major beneficiaries from this legislation because they have a relatively small amount of their total deposits in savings, which is the only category where reserve requirements are being increased.

The eventual result of this legislation would be the effective elimination of options available under the current dual banking system, because there would be no reason for any bank to remain a State-chartered bank. The current system gives banks the option between State and Federal chartering. The bill would increase inequitable treatment of individual banks within the banking system, and create a loss of freedom of choice for banks mandated to maintain reserves with the Federal Reserve System. The likely end result is a single monolithic Federal regulatory agency; and this type of control has seldom produced a good competitive atmosphere to serve the public. Taking away these options would have a negative impact, and the total effect of it would be impossible to assess without in-depth analysis.

If the purpose of the bill is to stop the erosion in Fed membership, we believe that the preferable route for solving this problem is to significantly lower reserve requirements, eliminate the graduated scale, and pay a money market interest rate on reserves and to have the Fed charge for services they provide. This has been our position for some years now, and we will continue to support efforts and legislation of that nature. We do not believe that the maintenance of non-interest-bearing reserves by members is a requisite for monetary control.

Thank you.

The CHAIRMAN. Thank you, Mr. McCrady.

Charles W. Hemann, vice president of the First National Bank of Arizona, in Phoenix, Ariz.

STATEMENT OF CHARLES W. HEMANN, VICE PRESIDENT OF THE FIRST NATIONAL BANK OF ARIZONA, PHOENIX, ARIZ.

Mr. HEMANN. Thank you, Mr. Chairman. My name is Charles Hemann. I have been an employee of First National Bank of Arizona for the past 8 years, and currently serve as the vice president, reporting to the chief executive officer.

First National Bank of Arizona is the State's oldest bank, tracing its roots back to the Bank of Arizona, which opened its doors in 1877. With total assets of more than $2.5 billion and total deposits exceeding $2.2 billion, FNBA is Arizona's second largest commercial bank and among the 50 largest commercial banks in the United States. Headquartered in Phoenix, FNBA provides a full range of commercial banking services through 135 statewide offices.

Our position on H.R. 14072 can best be summarized in the following points:

1. Due to the vast complexities of our Nation's banking system, a marginal reduction in required reserves for member banks and the imposition of reserve requirements on some nonmember banks would have, in our opinion, little discernible effect on the Federal Reserve bank's ability to exercise effective monetary policy.

2. While, as a Fed member bank, this bill would reduce our non-earning reserve account, we suspect the suggested advantages of such a move may prove to be more illusory than real. Should the freed excess reserves threaten a credit explosion, we believe the monetary

authorities would move quickly to absorb these dollars through other means.

3. The implication that a reduction in our reserve requirements would favorably impact on our earnings statement is presently clouded by the lack of any definitive information on the Federal Reserve's plans to charge for its services. In our opinion, the Fed will find a way to continue to extract profit opportunities from member banks, and the prospects of any marked change in the level of what amounts to an indirect tax paid to the Treasury Department would appear to be slim.

4. The imposition of Fed reserve requirements on nonmember banks could play havoc with traditionally correspondent banking relationships.

5. Finally, the dual banking system has served our country well. The bill opens the door to modifications of this system which could lead to its eventual demise—a prospect we view as detrimental to our industry's and our Nation's future.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, sir.

Allen Rosenberg, vice chairman, Great Western Bank & Trust Co. of Phoenix, Ariz.

STATEMENT OF ALLEN ROSENBERG, VICE CHAIRMAN, GREAT WESTERN BANK & TRUST CO., PHOENIX, ARIZ.

Mr. ROSENBERG. Thank you, Mr. Chairman. My name is Allen Rosenberg. I am the retired president, currently serving as vice chairman of the board of Great Western Bank & Trust, which has 35 branches in Arizona. We were founded in 1906 in Prescott, Ariz., as the Yavapai County Savings Bank, 6 years before statehood.

As the third largest State-chartered bank within the State, it is the opinion of Great Western Bank that the bill before this committee, H.R. 14072, would have an extremely adverse effect on our institution and the banking community throughout the United States. Based on average August 1978 deposit statistics for Great Western Bank, we estimate that the reserve requirements as stated in the above bill would cost that bank an estimaed $900,000 a year in pretax earnings. This would be equal to approximately 25 percent of the projected bank's earnings for the current fiscal year.

One of the major problems facing banking institutions and particularly medium-size banks like Great Western is capital generation. The bill would have a significant effect on the capital generation on Great Western Bank because of the effect on net income and, as a result, would limit the bank's deposit growth, loan growth, and the ability to service its customers in a manner to which they have become accustomed.

We strongly urge that the subject bill be subjected to additional review and that if changes need to be made in the present method of maintaining reserve requirements that other solutions be devised and implemented following further study which seems to us to be strongly and urgently indicated.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Mr. Rosenberg.

Now, Jack Davis, executive vice president of the United Bank of Arizona.

Mr. Davis?

STATEMENT OF JACK DAVIS, EXECUTIVE VICE PRESIDENT OF THE UNITED BANK OF ARIZONA

Mr. DAVIS. Thank you, Mr. Chairman. My name is Jack Davis. I am executive vice president of the United Bank of Arizona. We are a State-chartered nonmember bank of the Federal Reserve. We had, as of June 30, 1978, total assets of $458 million and total deposits of $415 million. We are the second largest State bank in Arizona and fourth largest in our State.

Passage of this proposed legislation would, in our opinion, have a devastating effect on approximately 300 banks which are nonmembers in the medium-size category. Based on the daily statement of the United Bank of Arizona as of September 15, 1978, sterile reserves in the amount of approximately $15 million would be required to be kept with the Federal Reserve bank. This converts to an earnings loss to our bank of over $1 million on an annual basis.

In the midfifties, when investment yields were very low—91-day bills dipped to 1 percent—the income loss from sterile reserves maintained with the Federal Reserve probably no more than offset the value of services which the Federal Reserve rendered to its members. In subsequent years, with investment yields substantially increased, the negative effect on earnings of sterile reserves has increased tremendously. The current loss from sterile reserves can best be measured by the $5.6 billion which was transferred to the U.S. Treasury from the Federal Reserve last year, much of which resulted from income from investment of reserves. Therefore, obviously, member banks' reserves could be lowered, which would make membership in the Federal Reserve much more attractive.

However, there are other more important and far-reaching reasons why this bill should not be passed. Probably the most notable negative effect from a national viewpoint would be the elimination of the major advantages of being a State-chartered institution which would result in the complete ruination of the dual banking system, a system which has worked well, as stated many times, for many years during all periods of the economic cycle. A system that has provided the banks with the freedom of choice, a system of competitiveness and, most important, a system of checks and balances—all of which would be eliminated.

All the banks in the State of Arizona from a $3.6 billion national bank to the smallest State bank are unanimously opposed to H.R. 14072. This legislation is not a consumer issue, and there are no public gains apparent that the membership problem of the Federal Reserve System be resolved by a reduction in present reserves and/or payment of interest thereon, thereby preserving the viability of the dual banking system.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Mr. Davis.

And now Robert F. Stone, president of the Continental Bank of Phoenix, Ariz.

STATEMENT OF ROBERT F. STONE, PRESIDENT, CONTINENTAL BANK, PHOENIX, ARIZ.

Mr. Stone. Mr. Chairman, my name is Robert F. Stone, and I am president of the Continental Bank of Phoenix, Ariz. We are a State-chartered, nonmember and have seven branches in Maricopa County. The bank currently has deposits of approximately $220 million and assets of approximately $235 million.

The committee bill would have a direct and significantly adverse impact on both Continental Bank and the Arizona economy. We started Continental Bank from a mortgage service company that had commenced operations in 1947. We are now the ninth largest mortgage servicer among commercial banks in the United States. We service approximately $450 million in mortgage loans. Arizona has always been a capital-short State, and there have never been sufficient funds generated in the State to support its growth. Continental Bank has sought to address this problem through its mortgage servicing activities by bringing funds to Arizona to meet the State's ever-growing needs. This year Continental Bank will originate approximately $100 million in FHA, VA, and commercial real estate loans. The committee bill would curtail this activity.

Taking into consideration Continental Bank's regular growth, we would conservatively have to withdraw approximately $6 million from the funds which we would otherwise make available for real estate loans. Applying to this figure our ability to convert construction loans into mortgage loans on a thrice yearly basis, the committee bill would thus have the effect of removing from the market approximately $18 million in Continental Bank mortgage money. Not only would this result in damage to the Arizona economy, but it would cost our shareholders approximately $600,000 in income a year.

The committee bill carries no offsetting benefits against these losses to the community and to Continental Bank. The Federal Reserve discount window would be of no help to us as we would continue to use our correspondent banks with which we have dealt over the years and which uniquely understand our business.

The ultimate effect of the committee bill, due to its adverse financial impact, would be to drive banks like Continental Bank out of State banking systems. Were the bill to pass, Continental Bank in all likelihood would be forced to convert to a national charter. The bill would thus deprive banks of the freedom to choose among State and national banking systems. This freedom has always been a cornerstone and a positive force in our banking system.

Continental Bank recognizes the Fed's need to exercise effective monetary control. This control can be achieved, however, without destroying the dual banking system. Membership in the Federal Reserve System should be encouraged, rather than compelled, through lower reserve requirements, interest on deposits, and other means. What is needed before any legislation is passed, however, is additional research and analysis. We are in sympathy with the requirements addressed by the committee bill and would be happy to cooperate in research designed to satisfy these requirements without tearing down the banking system which has well served this country for more than 100 years.

Thank you very much.

The CHAIRMAN. Thank you, Mr. Stone.

Now to round out the Arizona delegation, Robert Matthews, president of the Arizona Bank of Phoenix, Ariz.

STATEMENT OF ROBERT L. MATTHEWS, PRESIDENT, CONTINENTAL BANK, PHOENIX, ARIZ.

Mr. MATTHEWS. Thank you, Mr. Chairman.

Distinguished members of the committee, my name is Robert L. Matthews.

I am president of the Arizona Bank in Phoenix, Ariz.

We are a State-chartered nonmember bank of the Federal Reserve. We are primarily a retail bank. We have 79 branches serving the State of Arizona and our total assets are approximately $1,400 million. Our deposits are approximately $1,200 million.

I have been employed by the Arizona bank for some 19 years. Our bank is approximately 76 years old and was chartered and has always been a State nonmember bank. We are the largest State bank in Arizona and the third largest bank in our State.

The proposed legislation would have a very severe effect on the assets, liabilities, and capital structure of our bank. At the present time, if this legislation were enacted it would require us to set up a noninterest bearing or sterile reserve with the Federal Reserve Bank somewhere in the neighborhood of $45 million to $50 million. This means that for us to generate these funds it would be necessary for us to liquidate investments and loans to meet these reserve requirements.

Obviously, there are several different ways to do this, but I am saying it would have a very severe impact on the customers of our bank, the stockholders of our bank as well as the economy of the State of Arizona and not the least, our employees and officers.

Based on a conservative reserve ratio it would reduce the income of our bank about $4 million before income tax, roughly 25 to 30 percent of our 1978 earnings. Although the required reserves under your committee's proposal would require a 4-year phase-in, our State has a fast growing economy and if we could anticipate 10 to 15 percent increases in our deposits over this period of time, the effect would be further magnified.

One of the proposed advantages of this bill would be to allow State-chartered nonmember banks access to the discount window. We have never used a discount window, would have no plans to do so and if and when a need arose we feel that we could amply take care of the needs through our correspondent banking relationships.

In reviewing further your bill, we at this time can see no reason for us to continue as a nonmember State bank. In other words, if we are going to be required to set up reserves with the Federal Reserve banks it would be to our advantage to join the Federal Reserve for a variety of reasons, primarily because of cost.

In the State of Arizona at the present time, there are 19 commercial banks of which 3 are national banks and members of the Federal Reserve. The rest of the banks are all State-chartered nonmember banks.

I cannot foresee any reason why others would not follow us, eventually collapsing our dual banking system. If we were to withdraw from the State charter to a Federal charter, it would cause a significant reduction in the revenues of our State banking department which would have a severe effect on the quality of supervision and examination of the existing banks within the State.

I am pleased to speak on behalf of some of my other colleagues from other State nonmember banks and member banks on this issue.

It is our feeling that the proposed legislation would have a negative impact on the dual banking system. For the State-chartered nonmember banks, it would remove dollars from the State of Arizona which are badly needed to support the growth of our State.

Also, we do not feel that there is any case for emergency on the matter at this time and that certainly a proposed legislative issue of this magnitude should be thoroughly reviewed to study the impact on the different classes of banks which are affected, the impact on the State economies which those banks do business with, the impact on the local community and customers that these banks serve, the impact on the dual banking system which has been such a successful part of our industry over the years.

This legislation would have a very severe effect upon correspondent banking as it exists today and a thorough analysis of how this would affect the correspondent banking activity is certainly deemed necessary.

It is our opinion that if you and other supporters of this bill feel that emergency measures are necessary we would remind you that under the existing statutes the Fed could reduce reserves for the member banks to alleviate the membership burden.

Secondly, if it is necessary for the Fed to receive better information for monetary reporting of reserves we would be pleased to furnish any additional information as they would deem necessary. We feel that additional study is necessary to review the impact of this proposal as it relates to inflation and the monetary problems that we are having today in this country.

Mr. Chairman, we are in sympathy with the high cost of membership in the Federal Reserve bank. We are committed to the concept of having a central bank for our country. If there were a national emergency of some type we, of course, would be willing to do our part, but we do not feel that this proposed legislation answers the question properly and if the question of universal reserves for financial institutions is necessary for the betterment of our country then we would support the concept of universal reserves for all financial institutions regardless of size or type of industry, banks, savings and loans, or credit unions, and the like.

Thank you for your attention, Mr. Chairman.

The CHAIRMAN. Thank you, Mr. Matthews.

Our last witness on the panel, J. J. DeLay, president of the Huron Valley National Bank, Ann Arbor, Mich.

STATEMENT OF J. J. DeLAY, PRESIDENT, HURON VALLEY NATIONAL BANK, ANN ARBOR, MICH.

Mr. DELAY. Thank you, Mr. Chairman and members of the committee.

I wanted to be here and I am here.

I guess I am the only proponent on this panel that is in favor of the legislation. I think I am a people's banker.

I represent three generations of our family in the Midwest. I represent 425 banks, 5 States, Federal Reserve Board, Chicago; I am not speaking for the Fed. I am speaking as an independent, as a people's banker; 5,300 of the 5,600 banks, only 1 of $120 million and less, will be affected by this legislation. I think it is a major breakthrough. I think it is a framework for a new Fed and I disagree with some of my associates in regard to the destroying of the dual banking system.

I think it is the first profound breakthrough that we have had since 1933, and I am here to fight for it.

There are many things, not many things but things in it that are going to be watered down and amended but, basically, it is a good bill.

Section 1, let us take a look at the bill. I would call it, very frankly, instead of the Federal Reserve Act Amendments of 1978, the Reuss-Miller bill, in reference to the two individuals. I think it is a major breakthrough for the Chairman of the Federal Reserve and the chairman of this committee to sit down and exchange ideas and thoughts, as bringing new leadership into the Fed and to the banking committees to try to solve old problems, and they are there.

Let's take a look at section 2.

What is it? They are trying to get a better control of the monetary aggregates. Take a look at the paper today. The Fed estimated for 8 months 7.6 monetary growth. Well, what was it, 8.1. All right. Why? They did not have the handle on the nonmember banks, roughly 8,000 to 9,000 of 14,300.

That could have been a part of it, but I think that if you have the control, not only the reporting of those member or nonmember banks plus the S. & L.'s and the credit unions of this country, then I think the Fed, along with Congress and the administration, can get a better handle as to which direction they are going and where they have been.

I cannot see anyone complaining, very frankly, about not reporting to the Fed for those kinds of figures, whether they be on a weekly basis or a monthly basis, or a 90-day basis.

I think it is their duty as a financial institution to give those figures to the Fed in order for them to implement. After all, we have the greatest central bank in the world, the Fed, so let's support it.

Section 3. This is the guts of the whole ball game. You are going to bring in 293, roughly, new nonmember banks and these are banks of $125 million up to $1.2 billion, good banks. However, they gripe about what it is going to cost them; how about us, the 5,300 of us that have been paying the freight since the Fed was organized? Sure, I am selfish in the fact I represent 5,300 of 5,600 member banks, and that it is going to affect us more than anyone else.

But we are going to take those dollars, $12 billion, which is $37 billion reserves now being carried and the estimate is it will free up $12 billion, it won't be spread in my town. I will have roughly $2 million to $4 million that I can reinvest in my community, and every bank in the country, that is the member banks that are freed of this $12 billion reserves, will be able to buy the bonds, to pay the taxes, to reinvest in municipals, to give those student loans and take care of that small businessman.

The disparity of member banks and nonmember banks has been on since 1915 and in our family we have had Federal Reserve National

Banks since 1918. We know the subject. We know to whom we are addressing it.

For that disparity, let me just use an example. I am in a college town. I compared my bank with a State nonmember bank and by a corresponding university town. It costs my bank $150,000 above this bank in East Lansing, Mich. He has $150,000 below the line. He can take that $150,000, he can reinvest, he can provide maybe additional better services to his customers.

I can also start to build a higher capital base, and this is the main part of this bill. I think banks, particularly in that 5,300 and less, 5,300 of us will have a chance to build that capital base that we need. I think the flexibility is good. I think there is indexing in regard to—what Representative Bruce F. Vento mentioned about it—it is there, I saw it. I just got the bill yesterday.

Member banks will be exempt from State reserves and nonmembers will be exempt from State reserves requirements if their desposits exceed the exemption. Therefore, reserves will be satisfied in one agency or another.

I think you have in that section in regard to foreign banks coming in, opening up subsidiaries here, why don't they have a reserve requirement? They are competitive now with no reserves. They should have a Federal reserve, requirement, and control.

Discount window, I think it should be opened to nonmembers. Why not a bank that is a nonmember, to give them this privilege, I would rather have them go to the window. I think the Fed would rather have them go to the window instead of borrowing through the Fed fund market. I hate to borrow from my Fed. When I do, as far as I am concerned, up to this point I think it has been a black mark against my record.

I think it should be opened. We give our bonds, we pledge 100 percent, they are put in my reserve accounts and put in my demand shortage and reserve balance accounts, it is there, it is above board. If I have to borrow, why should I have to go to the Fed market? I don't believe in that.

I think the discount window should be encouraged to lend. I think lines of credit should be in that discount window to give flexibility. They are getting better.

Section 3, communication between the Board and the House Banking Committee and Senate Banking Committee I think is necessary. I think many times statements come out that one says this and the other this. Get together. I think they are bumping heads. I think it is for the good of the Fed.

The Fed was created by Congress, yet they still have independence, this continues.

The phasing in, good. I think 3 years on one side, 4 years is sufficient to take care of the banks that are coming about. What is it going to cost them?

The form of reserve, section 5. There is the problem, the whole bugaboo in regard to correspondents. Some of them help me, some do not. They are necessary and they are part of the banking system. However, I think for the first time they will have to take a look and see what is the correspondent bank relationship with this bank out in Pocahontas, Iowa, or wherever it may be.

The cost of servicing. All over the ballpark. I think it depends upon how much the traffic can bear. I think you will bring it down to a real pricing system, which will be good for the banking system.

Section 6, funds market, I think that Fed funds, the short-term borrowings, repurchase agreement should be under the Fed. I think there should be some kind of requirement. I think that is a dangerous deal and I think it should be controlled.

Section 7, studies of specific proposals, study of banks investing in certain reserves with interest bearing governments. I think that is good. I think it should be in the feasibility study and also the reserve requirements of the other outside financial institutions, the thrifts and credit unions.

Next, pricing. I think the Fed, July 1, 1979, is part of that, and they are looking at the pricing of the services. I know the correspondents are. I think that when you get down to it, it will be a more competitive factor in regard to what a bank will have to pay, whether you go through the Fed processing our checks or holding your governments there, or through a correspondent bank.

I think it's going to be competitive as heck, and I think I would put my money on the private sector to outprice the Fed.

Section 9, interest on reserves. I think that is good.

Section 10, effective dates. That makes sense to me. I think overall it is a good bill. I am in support of it. I am not speaking for all of my banks that I represent, and I am not speaking for the Fed.

I am speaking as a people's banker and there are 5,300 out of 5,600 in the system and there are about 13,900 out of 14,500 banks in the country. We are the guts of banking, we feel, to our communities. We need the big banks, and I use them, but it's a different ballgame.

I am in support of the bill and I think it would make a stronger Fed, I think it would be a stronger central bank and, as a result, it would be a better banking system and better economy for 220 million people.

Thank you.

The CHAIRMAN. Thank you, Mr. DeLay.

I will call first on our distinguished Representative from the State of Michigan, Garry Brown.

Mr. BROWN. Thank you, Mr. Chairman.

A bit belatedly, Mr. DeLay, I just want to welcome you to the committee and to this hearing. Mr. DeLay is a well known banker in Michigan, and I think that his testimony speaks for itself and the only thing I wish to do is just apologize for not being able to be here to introduce you when you first appeared. Good to have you with us.

Mr. DELAY. Thank you, sir.

The CHAIRMAN. You all have made a contribution to our learning here, and I could take some hours to converse with each one of you, which obviously would be unfair to the third panel which is waiting in the bullpen right now. But I would have a question or two of first our friend, Mr. Matthews from, what are you, the third biggest bank in Arizona?

You are right up there.

Mr. MATTHEWS. That is correct; we are the third largest. We are the largest State bank, but the third largest bank in Arizona.

The CHAIRMAN. I just wanted to ask you about one point you made.

You said, if I heard you rightly, that if this bill went through you would feel compelled to join the Federal Reserve System.

Mr. MATTHEWS. I said that yes, I did, primarily because of cost.

The CHAIRMAN. And you have been getting along all right?

Mr. MATTHEWS. Yes, sir, I think we have.

The CHAIRMAN. You have $1 billion in deposits and life goes on for you all right?

Mr. MATTHEWS. Yes, sir, it does.

The CHAIRMAN. Is that not correct?

Mr. MATTHEWS. That is true.

The CHAIRMAN. What is your prime rate now?

Mr. MATTHEWS. It is 9½ percent.

The CHAIRMAN. No criticism of that by me. That is what all of the banks are having to charge.

Mr. MATTHEWS. That is correct.

The CHAIRMAN. What I can't understand, though, is, in the event this bill is passed, since we deliberately did not want to make it a closed shop bill and we did not mandate membership in the Fed—as many officials inside the Fed, in days gone by, have wanted—what you would tell your stockholders when some smart aleck got up at an annual meeting and said, why aren't you making 9½ percent and better on our money, why are you taking that miserable 6 percent that the Fed is paying you on the amount of our capital that you have to put in?

How would you answer that?

Mr. MATTHEWS. Well, you know——

The CHAIRMAN. Today you have to answer stockholder questions.

Mr. MATTHEWS. That is correct. I think, Mr. Chairman, first of all, that the first problem if this bill came up, the first thing I would be taxed with is I would have to come up with about $4 million, a loss of about $4 million, before taxes.

The CHAIRMAN. Correct. Your extra deposits, your reserves, which you now don't have to put up, would be about $37 million.

Mr. MATTHEWS. No; they would be more in the neighborhood of $45 to $50 million.

The CHAIRMAN. I will accept your computers rather than ours. But, you would have to pay your share of the cost of our Nation's anti-inflationary prodollar monetary policy just like all of the member banks, and you would have to do that whether you were a member or not.

Why then, since you have been getting along fine for many a year would you want to give up money for which you can get 11 percent or 10 percent or 9½ percent, for 6 percent money?

Mr. MATTHEWS. I am not really sure I understand the point you are trying to get at, but I think if you are looking for the reason as to why we would want to join the Fed——

The CHAIRMAN. Yes, sir.

Mr. MATTHEWS. To do this, what the choices would be if we went to this Fed, the Fed unbundled their prices, would be the question of why would we want to go to a correspondent bank and buy our services, or some of the services through them which we need now which we don't have.

The CHAIRMAN. I am glad I asked the question, because, and I certainly am not being critical of you, the bill does provide that Fed services shall be available to nonmembers on precisely the same terms as to members.

The bill further provides that the discount facility which, as you say you have not used, but better to have something——

Mr. MATTHEWS. There are some advantages to Fed membership as far as wire transfers and things of that nature, which would be coin and currency shipments and all these things.

The CHAIRMAN. But you can buy those as a nonmember on precisely equal terms as you could as a member. I am just preparing you for the day when this may happen and when some persnickety stockholder may stand up at an annual meeting. Though, of course, if our interest structure is then such that your prime interest rate is 3 percent you will have a marvelous answer, you will tell them you are making 6 percent at the Fed and it is good business.

Mr. MATTHEWS. I guess we are just not communicating on the same levels.

The CHAIRMAN. If you join the Fed, you know, you have to put up capital.

Mr. MATHEWS. That is correct; I understand that.

The CHAIRMAN. You get 6 percent on it.

Mr. MATTHEWS. That is correct.

The CHAIRMAN. But, your prime rate is 9½ percent; why don't you use the money you would be proposing to pay the fund at the Fed to make 9½ percent loans to your prime customers or 10 or 11 percent loans to your less prime customers?

Mr. BROWN. Would the gentleman yield just briefly?

I was not here and I apologize.

Did Mr. Matthews testify that he would want to join the Fed?

Mr. MATTHEWS. I said more than likely if this bill were to pass, I say there would be really no apparent reason for us to continue as a State nonmember bank, that it would be better for us to then go directly to the Fed.

The CHAIRMAN. I won't pursue it.

Mr. MATTHEWS. I think there are a lot more factors involved than just the difference between 9½ and 6 percent, which you brought up and, of course, this is one thing I got back to in my testimony here, is I think we need a lot more time to study the consequences of the bill other than just picking out pieces about it.

The CHAIRMAN. Absolutely, I said you have not had much time.

Mr. MATTHEWS. I think it is just an indirect form of taxation on the other nonmember banks, which is hard for me to justify.

The CHAIRMAN. The counter argument, of course, is that a bank charter is a useful thing. You would sooner have one than not have one, I am sure, otherwise you won't have that nice billion plus dollars of deposits. And a bank, unlike almost any other form of business organization, is protected against interstate competition by a very wise bill which recently became law, it is protected against unfair foreign competition, and it certainly should be.

A bank, unlike a savings and loan or other nonbanking institution, may create manna heaven, that is to say it may set up a deposit for someone, it may make money.

Congress, in effect, has delegated its money creating power to the banks, and so for a long—these 60 years or so—the member banks of the Fed have been viewed by many as paying a fee for taking part in this select group protected against full competition, given recently a statutory ceiling on the commodity it buys, money, yet given complete freedom to charge whatever it wants to those who wish to borrow from it.

These are, indeed, unique privileges, and the feeling of the majority of the committee was that the only fair way to do it was to see that the 200-odd banks who either have never been members of the Fed or have resigned from the Fed and who are large enough to make a substantial monetary difference should be included.

I know you don't agree with that, but I simply wanted to state it.

Mr. MATTHEWS. I understand what you are saying, but I don't agree with it, that is correct.

The CHAIRMAN. Right, and were I in your position I can assure you I would not agree with it, either.

Mr. Watkins.

Mr. WATKINS. Thank you very much, Mr. Chairman.

I would also like to express my appreciation for your being with us this morning.

Mr. Chairman, I want to express to the witnesses that this has been a very interesting bill and one that I have been receiving a lot of discussion on in the last few days.

I came to Congress as a homebuilding, land developer and real estate person, and I have always had a great esteem and a deep appreciation for a good banker.

One of the things I have always appreciated about a banker as a businessman, is that I can rely on our agreement, and commitment to each other even though it may not have been handled completely in writing.

The chairman has had a lot of hearings on this bill. Up to now most of the things being discussed were positive and not negative.

I wanted to express to you my concern for this late entry into expressing some strong resentment on some of the legislation. I think your comments could have had more impact and given a lot more direction if they had been received earlier. As I say, I am an individual who has a deep appreciation for a good banker. I have borrowed money and I have worked with the financing all the way through in my business.

I think anyone from Arizona knows that there has been tremendous development in that part of the country. The builders you work with are appreciative of your helping them with their cash flow problems, meeting payrolls and all of these different things.

What I am trying to say to you is that I would like to encourage you, in taking care of your business, to input on legislation a lot quicker.

I think there are some things in this bill that are being read into it, and that it is not all in black and white.

Let me say this also. I am probably as strong an advocate as you will ever meet for the dual banking system. I have tried to read and study the bill, to try to see where we are.

I know my bankers in Oklahoma, for whom I have deep respect, have a general consensus of being against the bill. I have sat down and talked to them at great length and I have also said to them the same things I am saying to you; that you need to provide earlier input on legislation as it is being directed, and not come in at the 11th hour and try to give some opinions which I think are justified.

It sure helps us as we try to work and mend and blend our thoughts and suggestions if your opinions are all in a lot earlier. Let me say this, gentleman, I come from an area of the country in Oklahoma where hand shakes and commitments are important, and as long as you don't get that information in and those agreements made it makes it difficult.

It is kind of like a banker backing out on a guy who has a loan made to buy that piece of property if he wants to develop it. Let me tell you, it's tough, when you as an individual in Congress work with people on a day-to-day basis and you have to go to them and say, hey, my people are concerned about this legislation and they feel like it is going to be harmful.

I would just like to express to you as a businessman that I hope you will try to be more involved in trying to be in on early developments of the legislation.

I do want again to express my thanks to each of you. I know your individual Congressmen, they are great people, and as strong advocates of the free enterprise system in the business community. I think those individual Congressmen you have sent here are doing a great job.

Mr. Chairman, I didn't have a question. I wanted to express to them as a freshman Congressman, who is learning a great deal and has been here only 2 years, as a businessman, and as one who has been deeply involved in working with bankers that if you have a concern about legislation, I suggest you try to get that input in early. Because agreements and commitments are very precious things as you work with people here in this body. It is the same way with the working relationship and agreement that you have with clients and constituents who are your customers.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you.

The gentleman from Minnesota, Mr. Vento.

Mr. VENTO. Thank you, Mr. Chairman.

I looked at the figures that we have on the State of Arizona and it seems like a good number of the members at the table are from Arizona and the net benefit to the State, not necessarily to the individual institution, is $950,000, so the net effect is to have less sterile reserve requirements at the Fed on a statewide basis than what is occurring today.

Mr. Rosenberg and Mr. Matthews both pointed out a change in their profit picture before taxes and I went through my data and found that the Great Western Bank & Trust Co. of Arizona, which Mr. Rosenberg is associated with, has a net reserve requirement of $5,573,000.

That is the increase in reservable requirements, of course. What would you deposit with the Fed on that basis, what would the vault cash adjust out, Mr. Rosenberg, and that is the figure we should be using in evaluating what the impact is on your bank's role, what is the reservable requirements in that amount under this bill?

Mr. ROSENBERG. Mr. Vento, our senior vice president for finance informed me yesterday that it would be, additional——

Mr. VENTO. I heard the $900,000 figure, but I wanted to know what you had to deposit with the Fed on that basis.

Mr. ROSENBERG. We are not a member.

Mr. VENTO. I know, but what would you deposit under this bill? That is what we are talking about.

Mr. ROSENBERG. I started to tell you I was informed yesterday it would be a little over $10 million.

Mr. VENTO. That is the reservable requirement minus vault cash turns out to be $5.6 million reservable requirement under this bill.

How much of your deposits are time and how much are demand? I don't know that figure. That is why I can't work it out for you. I would work it out quickly if I knew what your percentages were, and then just adjust the 6 and 7 percent figure against them, and then we would have what would be the holding. The reason that becomes important, Mr. Rosenberg, is because you mention a loss of $900,000.

I don't think your reservable requirements are that much, first of all, and then, second, of course, you are assuming if you did have that money, the leverage, you would earn a tremendous amount of profit on it, which I don't think is necessarily characteristic of your other types of investments, and that is where the whole thing breaks down in terms of what we are discussing here.

I realize you can leverage with money in your hands as opposed to the Fed, but I guess I would dispute or at least would question the statements that have been made about how much you can do with that money even in the Fed.

You realize that is an asset that is liquified, not as liquid as you would like but certainly not a complete loss in terms of what you are able to do. If you have money with the Fed, I think you can do things you want to do. It does limit flexibility, but it's not a complete loss plus, of course, there is the discount window.

Do you utilize the discount window through any of the institutions you are associated with today, Mr. Rosenberg, at all?

Mr. ROSENBERG. Only by way of dealing with a correspondent bank.

Mr. VENTO. I see. So, indirectly you do and can benefit, but this would be, of course, a savings if you could deal directly, I assume with them. So, this is the point I want to make and I think it's equally appreciable, though I didn't write down Mr. Matthews' figures.

I think it is equally appreciable to what he was saying with regard to profits and I think those are the questions we have to resolve or should be sorting out. You can answer those questions, because you have the capacity to tell me what you have in time or demand deposits, and if you could or would, I think then we could get a better idea of whether or not you really lose 25 percent of your before-tax income.

Mr. ROSENBERG. I would like to make this suggestion to you, Congressman Vento. Let me get the exact figures, and forward them to you. I think I know your address, and I will be glad to send them to you.

Mr. VENTO. I think you might send them to the committee and they will then share them with all of us. Then we will have an answer to the questions because I think reading your statement, no one wants to see you lose 25 percent of your income, and I would contest, based on your response that it is going to occur, so I am challenging you to do that.

Mr. ROSENBERG. Fair enough.

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Mr. MATTHEWS. Congressman, on behalf of the institution I work for, that the reserve figures——

Mr. VENTO. Which institution?

Mr. MATTHEWS. I am with the Arizona Bank, and the figures I gave you, the range of $45 to $50 million is a figure after cash reserves have been subtracted out.

Mr. VENTO. After cash reserves and you say you lost $45 million a year?

Mr. MATTHEWS. No, that is the amount of reserve.

Mr. VENTO. And is that on $3.7 billion, what is the total figure of your reservable requirements with the Fed?

Mr. MATTHEWS. Under the proposed bill that you have that we are talking about today the reserve requirements for our bank the way we figured it out on a net basis would be somewhere in the area of $45 to $50 million.

Mr. VENTO. It is $37 million. We have the figure before us minus vault cash and on that basis you are losing—what was your figure?

Mr. MATTHEWS. I don't know what the date is of the figures you are using.

Mr. VENTO. The date is today. These are computer runouts of December, and the report came to us today.

The CHAIRMAN. Whether it is $38 or $45 million.

Mr. VENTO. The point is, of course, the only way you can answer that is if you have the figure breakdown for time of deposit of that. How much is time? Using the figure $45 million, how much is time?

Mr. MATTHEWS. Of total deposits, we run about 32 percent demand deposits and the rest are time.

Mr. VENTO. What are your reservable requirements, what is going to be held by the Fed, what would you be depositing, based on this bill?

Mr. MATTHEWS. Based on the way the bill is written today, the way we interpret, on a net basis, it would be somewhere in the area of $45 to $50 million would be the account we would have to maintain.

Mr. VENTO. And your loss on that is what?

Mr. MATTHEWS. Pardon me?

Mr. VENTO. What is your income loss?

Mr. MATTHEWS. It will be an on and after tax basis. I said our income loss on a before tax basis, it would reduce our income about $4 million, which would be somewhere——

Mr. VENTO. Billion or million?

Mr. MATTHEWS. $4 billion, I wish. It would be about $4 million before taxes, based on this year's projected earnings.

Mr. VENTO. You said you don't use the discount window. Do you use the discount window for any of your 19 banks?

Mr. MATTHEWS. No; we do not. We overline some credits to them that are too large for us, but other than that we do not.

Mr. VENTO. You mention that you felt that we had responsibility to maintain the dual banking system. The fact is the banks have opted for the least stringent type of reserve requirements in order to attract banks to join the State banks.

Do you disagree with that? What types of sterile reserve requirements do you have in Arizona?

Mr. MATTHEWS. We maintain reserves under the statutes of the State which are 10 percent demand deposits and 4 percent on time.

Mr. VENTO. Are those sterile?

Mr. MATTHEWS. No; they are not.

Mr. VENTO. In other words, they are not sterile reserve requirements so you actually then receive and can receive an income on them; is that accurate?

You can receive an income on those?

Mr. MATTHEWS. We can invest part of those. Some types of instruments are eligible for meeting the reserve requirements; that is true.

Mr. BROWN. Would the gentleman yield just briefly?

Mr. VENTO. Yes; I yield to the gentleman from Michigan.

Mr. BROWN. What reserves do you maintain? You are required to maintain 10 and 4. What, since they are not sterile reserves, what is your present level of maintainance of reserves? Do you keep right to the 10 and 4 or are you in excess?

Mr. MATTHEWS. No; we are way in excess because of the way they are counted. I do not have the exact figures here with me, but I will be glad to submit those to you if you like.

Mr. BROWN. Basically, because they are not sterile. If you were sterile you would be down to the very minimum, wouldn't you?

Mr. MATTHEWS. That is correct.

Mr. BROWN. Thank you.

Thank you for yielding.

Mr. VENTO. I yield back.

The CHAIRMAN. Did you wish further recognition, Mr. Brown?

Mr. BROWN. Since I have not been recognized other than to introduce Mr. DeLay.

The CHAIRMAN. You are now recognized.

Mr. BROWN. Let me go through a simple question and answer with the whole panel, since it seems that way we get the greatest input.

The first question is how do you assess the holding of reserves directly or indirectly by the Fed as you would in the present bill?

There are three categories of answers I would like. Substantial impact, little impact, relatively no impact.

Again, the question, holding reserves directly or indirectly by the Fed. All of you who feel that the holding of reserves by the Fed directly or indirectly, has a substantial impact on monetary policy, raise your hands, please?

[No hands raised.]

Mr.BROWN. All those that think that would have little impact upon monetary policy?

[Show of hands.]

Mr. BROWN. Really no impact or only a little impact. Substantial impact, relatively no impact. OK. Substantial?

[No hands.]

Mr. BROWN. Little impact?

[No hands.]

Mr. BROWN. Relatively no impact?

All hands, I guess.

Next is a similar question:

The requirements of maintenance of minimum reserves not directly or indirectly by the Fed. The two things are under the present bill; they have to be held directly or indirectly because there is a pass-through provision, you know.

This says you would have minimal requirements without their necessarily being held by the Fed, otherwise under State law. The same situation:

Substantial, little or no impact.

Substantial impact on monetary policy again?

[No hands.]

Mr. Brown. Little impact?

[No hands.]

Relatively no impact?

All hands.

All right; those two questions relate to monetary policy, the next questions relate to Fed membership.

Holding of reserves directly or indirectly by the Fed as in the present bill.

Impact on membership, substantial, little or no.

How many of you think that would be substantial impact on Fed membership if they are required to be held by the Fed?

Mr. DeLay. Would you restate your question?

Mr. Brown. Yes; the impact of legislation requiring reserves to be held by the Fed, how that would impact on membership in the Fed.

OK, everybody.

Next, little or no, I suppose nobody.

So the reserve issue is purely of Fed membership, isn't it?

Mr. Matthews. No, sir.

Mr. Staley. And the dual banking system, what happens to it?

Mr. Brown. I mean to the extent the bill is aimed at two things, one, it seems to me to get a better handle on monetary policy and the other is Fed membership. So I am just trying to separate, for instance, the reporting requirements of the bill clearly impact upon monetary policy, and then we are talking about reserves, do the way in which you handle reserves have anything to do really with monetary policy and I think we have agreed that it has very little impact.

Therefore, the reserve aspect of the bill relates primarily to Fed membership, don't we agree with that?

Mr. Matthews. On that basis.

Mr. Brown. But if we are talking about Fed membership there are all kinds of gimmicks you could apply, I think.

For instance, you could charge in your pricing and services, you could charge correspondent banks some way, draft it so the correspondent bank had to pay a heck of a price for its services, so there would be little advantage for a nonmember bank to deal with a correspondent bank because the correspondent bank would have to pass through either by balances or by charges, and if that happened then it would be cheaper for that nonmember bank to become a member, right?

All I can say is there are lots of other little things that can be done, the permitting of reserves to not be sterile reserves payment on reserves.

Yes, Mr. Staley?

Mr. Staley. Mr. Brown, that may be true in theory but in practice what does the little bank do about clearing its items, a little country bank?

He is not going to send them, for instance, in my case, to Los Angeles. So he is going to send them to a correspondent, so now he is going to have to pay his correspondent bank for the service and he is going to have to be a member of the Fed.

Mr. BROWN. I am saying you could, in effect, because a shift to Fed membership, if the Fed came up with a pricing of services which was discriminatory against correspondent banks, so that the individual banks instead of going through the correspondent bank could become members of that and members of the Fed, so I am saying there are all kinds of little things if you are looking at Fed membership, and that is the things the reserve requirements are aimed at, so it seems to me we have not really examined this thing as thoroughly as we can if we are looking at Fed membership insofar as the whole discussion of reserves is involved.

I will forego the rest of my questions, Mr. Chairman.

The CHAIRMAN. Mr. Rousselot?

Mr. ROUSSELOT. Mr. Chairman, you will pardon me if some of us get mixed up, $35 million, $50 million, we get confused, we spend billions here, you understand.

Mr. VENTO. If the gentleman will pardon me——

Mr. ROUSSELOT. I will, absolutely. I will yield to you because you are the one that did it.

Mr. VENTO. I appreciate the gentleman's understanding of this freshman member.

Mr. ROUSSELOT. I want them to understand we deal in billions, we go in debt billions every year, so it's hard for us to cope with minor amounts. You know the gentleman here was talking about he might lose $4 million income and we are not used to that kind of thing.

Mr. BROWN. Would you yield just a second?

The best example of that I think was someone told me one time if you take and lay $1,000 bills in a pile, flat down, $1 million would make a stack 9 inches high. If you did the same thing with $1,000 bills to reach $1 billion, it would be higher than the Washington Monument.

Mr. ROUSSELOT. We are higher than the Washington Monument all of the time here.

The CHAIRMAN. Can we return to the regular order?

Mr. ROUSSELOT. Yes, sir.

If each of you were in our place, how many of you would vote for this legislation that is already voted out of this committee?

One.

Out of how many are there here?

Thirteen.

Mr. Harper, I was interested in your comment in your printed statement that the Federal Reserve Board does not, by the way, as I understand it, as receipts of your banks run from $21 million to $4 billion, so we have a wide range of banks here, and it isn't like we have all big or all small.

Mr. Harper, your second point, the Federal Reserve Board does not need reserve setting authority overall of the State chartered banks as a monetary policy tool.

Can you expand on that?

Mr. HARPER. I added a little in my oral comments.

Mr. ROUSSELOT. I apologize. We have been running back and forth.

Mr. HARPER. I added a little additional in my oral comments referring to control of banks of $100 million in assets as a monetary tool. My point is I don't think this is what is needed totally for control of monetary policy. I don't think it is going to enhance the Fed's ability to control money that much.

I think the other gentleman over there a little while ago elaborated on what the control of the money supply was by the Fed at this time, and by having these additional banks in it we are not talking about that much difference in control.

Mr. ROUSSELOT. So it really does not impact monetary policy that much.

Mr. HARPER. In my opinion, no.

Mr. ROUSSELOT. You see, that is one of the reasons we are told we need it, because it will do that, but you are saying you don't agree with that decision.

Mr. HARPER. No.

Mr. ROUSSELOT. And you gave enough reasons on the record.

Anybody else want to comment on that?

Mr. SNYDER. To the extent it theoretically restricts the levels of reserves that may be required by the Fed, its acts to reduce their power to control monetary policy if, in fact, that does.

Mr. ROUSSELOT. Anybody else want to comment on that question?

I know it's far past lunchtime, but we will try to hurry this up.

Mr. Matthews, I was interested in your statement.

I am sorry my other colleagues didn't pick this up because we are always worried about consumers here.

You say, "I can assure you it would have a severe impact upon the consumers of our banks."

Then you go on to say stockholders also. Do you want to elaborate on that as to why? You did a little bit in your statement.

Mr. MATTHEWS. I will be happy to.

Mr. ROUSSELOT. This bill would impact your consumers.

Mr. MATTHEWS. That is correct.

Mr. ROUSSELOT. Why?

Mr. MATTHEWS. I will tell you why, because if I have to come up with $45 million to $50 million——

Mr. ROUSSELOT. It is not $35 million like our printout shows?

Mr. VENTO. Mr. Chairman, if the gentleman will yield on that point, the printout I have is on the basis of December 31, 1977, which was the information we had presented to us today. But I might add Mr. Matthews is not altogether clear how much he has in terms of demand, that is demand deposits or in time deposits so, Mr. Rousselot, this is not as serious as you thought it was.

Mr. ROUSSELOT. I guess we heard differently.

Mr. VENTO. I don't think he knows exactly the percentage.

Mr. ROUSSELOT. I think he knows better than you do.

Mr. VENTO. Because there is some flexibility with regard to what the Fed can set in these bands, as you recall, Mr. Rousselot, from 1 to 6 percent to 8 percent, so there is another variable we all have to consider in looking at this legislation.

Mr. ROUSSELOT. You always have lots of variables you would like to look at. Would you like to comment further? Do you know what your reserves are?

Mr. MATTHEWS. Yes, sir, I certainly do.

Mr. ROUSSELOT. Do you think you know better than he does?

Mr. MATTHEWS. I would certainly hope so.

Mr. ROUSSELOT. Go ahead, get back to the statement.

Mr. MATTHEWS. Anyway, if I have to come up with that type of money to generate those funds to put into the Fed, where am I going to get the money, because I don't just have it laying around somewhere. Everything we have is invested primarily in loans. So for me to come up with that type of money I have got to then cut back on my loan portfolio, and if you are looking at $30 to $40 million decrease in your loan portfolio, where are you going to get it?

Mr. ROUSSELOT. What kind of customer does that affect?

Mr. MATTHEWS. Let me get to that.

We are primarily a retail bank. We have over 60 percent of our loans either in real estate or consumer oriented ,and that is right where the brunt of the whole thing is going to come.

Mr. ROUSSELOT. Are these mostly big business or just small and medium size?

Mr. MATTHEWS. No. I said we are primarily a retail bank, which means we are a branch bank and we deal primarily with individuals, the household-type deal.

Mr. ROUSSELOT. Household type, consumers would be affected then by this legislation.

Mr. MATTHEWS. That is correct, car loans.

Mr. ROUSSELOT. Personal loans?

Mr. MATTHEWS. Car loans, second mortgage loans, home improvement loans, and first mortgage loans on homes.

Those would be the primary categories in our portfolio.

Mr. ROUSSELOT. Do any of the rest of you have that same potential impact? How many of you would have a similar impact?

Can we see hands?

One, two, three, four, five, six, seven, eight, out of the panel here, Mr. Chairman.

That disturbs me that we would be severely impacting customers or consumers. I guess we had not talked about that before, had we, Mr. Chairman?

The CHAIRMAN. To answer your question, I think it would be rude of me——

Mr. ROUSSELOT. No; I want to get right in this.

The CHAIRMAN. The gentleman is surely aware that the sociological base of his Gallup, Rover, Rousselot, poll here today——

Mr. ROUSSELOT. It is the panel you invited, the panel.

The CHAIRMAN [continuing]. Is less than perfect. The gentlemen who appear here in general are those who are subject to an adverse impact by our bill, and it is not only natural but normal and healthy for them to object to it. Therefore, I am amazed we got one vote for the bill.

Mr. ROUSSELOT. Are you?

The CHAIRMAN. And I shall never forget J. J. DeLay of Ann Arbor, Mich.

Mr. ROUSSELOT. Well, you know how I feel.

It is called a minority. Now you know how I feel as a 2-to-1 minority.

Mr. DeLay. May I answer your question, because each said it would be impacted. I think as far as my bank is concerned, and I am a $110 million bank, I think that frees up $2 to $4 million reserves. This is one bank. There are 5,300 of them that would free up additional reserves plus the banks that are even up to $2 billion.

They are going to have $100 million off their base, and as a result, there is going to be $12 billion that can be placed throughout the country.

Mr. Rousselot. Of course, you understand we keep getting different figures depending on the latest updates on the computer run.

Mr. DeLay. I would take another exception.

Mr. Rousselot. How many new customers would you be able to provide additional loans for?

Mr. DeLay. We believe in lending money. We are 72 percent loan to deposits, 50 percent in real estate, 23 percent installment loans, and about 18 percent in——

Mr. Rousselot. This releasing of reserves would improve your ability to serve how many customers?

Mr. DeLay. I don't know how many. But I think if I have 4 million out there, I will be lending roughly 2½ million, if available for good prudent lending.

Mr. Rousselot. So he has what he considers will be a loss of $45 million to $50 million; you have an increase of $2 million to $4 million. That doesn't quite balance off. In the same State?

Mr. DeLay. No; I am Michigan.

Mr. Rousselot. Well, Mr. Chairman, I appreciate this panel being here. I think it was very generous of you to invite them.

The Chairman. If I may interrupt, I think it is generous of them to make the trip here, and I appreciate it.

Mr. Rousselot. I do, too, and I think it was good of you to make sure we did that before we went to the floor with this bill. And now I will pass on my additional suggestion. If you gentlemen could give use some kind of an idea between now and the time this comes to the floor as to how we might amend this bill to improve it, so your customers won't be so adversely affected, we would like to know that. Or if it is just impossible to improve the legislation to prevent that adverse effect to customers, we would like to know that, too.

Thank you, Mr. Chairman.

The Chairman. Thank you.

Mr. Vento?

Mr. Vento. Just one other observation. There is a band of effectiveness in terms of any amounts, and certainly the gentleman from Arizona perhaps knows what his reservable requirements would be; perhaps he can read the minds of those in the Fed setting those figures. I, for one, cannot. But that is understandable. I don't think I am expected to know exactly what he has in time deposits versus demand deposits. It is a changing thing that changes every day, and I think that is the difficulty here, and that is why he gave us a figure of $45 million to $50 million. The data I had was based on December of 1977. Apparently you have experienced phenomenal growth since then.

I would just like, in a general statement, to suggest what you are asking us to believe is that on a basis of about a 7-percent reserve requirement, that you do not now experience that you are going to lose 30 to 40 percent as your figure of your loan capacity, or, for instance, in the case of Mr. Rosenberg, on the basis of a 7-percent reserve requirement that you are going to lose 25 percent of your income.

I find it very interesting that on 7-percent of your equity, and maybe it is possible, I guess I would like to know how, that you are going to lose 25 percent of your income. I thought perhaps all of your assets earned an equal percentage. Plus the fact that these funds are not lost. They are available in terms of liquidity for bankruptcy. They are certainly something anyone would take in consideration that has stock in your bank or doing business with you.

I yield back the balance of my time.

The CHAIRMAN. I want to personally thank the members of this panel for their able, sincere contribution, and now we welcome the third and last panel. I apologize that we are about an hour late, but I think the time has been well spent. We now welcome to these well-worn seats, Jeremiah P. Shea, president, Bank of Delaware of Wilmington, Del.; Joseph C. Tisdall, executive vice president, Farmers Bank of the State of Delaware, Wilmington, Del.; William W. Geddes, president of Wilmington Trust Co.; J. H. Tyler McConnell, president of the Delaware Trust Co.; Elizabeth J. Lattanzio, president of the First National Bank, Wilmington, Del.; Andrew Boemi, of the Madison Bank & Trust Co. of Chicago; my old friend, Dr. James J. O'Leary, vice chairman of the U.S. Trust Co. of New York; L. Glenn Orr, Jr., president, Forsyth Bank & Trust Co., Winston-Salem, N.C.; Lewis R. Holding, president, First Citizens Bank & Trust Co., Raleigh, N.C.; Ben Craig, president of the Northwestern Financial Corp., North Wilkesboro, N.C.; John McNair, III, vice chairman of the board, Wachovia Bank & Trust, Winston-Salem, N.C.; and Dr. Charles Haywood, vice chairman of the Bank of Lexington, Lexington, Ky.

Ms. Lattanzio and gentlemen, you are most welcome. We will proceed as we have with the other panels, and your written statements, to the extent you have them, are received in full in the record, and would you now start off, Mr. Shea?

STATEMENT OF JEREMIAH P. SHEA, PRESIDENT AND CHIEF EXECUTIVE OFFICER, BANK OF DELAWARE, WILMINGTON, DEL.

Mr. SHEA. Thank you, Mr. Chairman.

My name is Jeremiah P. Shea. I am president and chief executive officer of the Bank of Delaware, headquartered in Wilmington, Del. We are a strongly loan-oriented bank with a loan-deposit ratio that reflects a consistent, long-range effort to place and keep our resources at work in the Delaware community.

I stress this fact because of the principal and immediate adverse effect we see taking place if we are required to immobilize earning assets—lendable/investable funds—in an account at the Federal Reserve Bank of Philadelphia. By our calculation, we would give up control of $25 million of earning assets with very little offset. We are heavy users of correspondent bank services, compensating them in most cases with deposit balances. These operating reserves would continue to be held in their present size and locations, creating the curious and unbusinesslike situation of paying for and receiving services from another supplier.

Our bank has 5,700 shareholders, none of whom hold as much as 1 percent of our equity. These people, including many pensioners and others dependent on dividend income are located mainly in the mid-Atlantic area and they are the ones who will pay for this arrangement through the loss of 18 percent of the earning power of the bank.

We all face rising costs. They are a fact of life. We try to trim them, control them, offset them. Once in a while a cost is introduced that is so significant it must be protested in every way possible, because there is no offset to it other than a substantial change in the way of doing business. In our case it will be a curtailment of lending, a new conservatism in loan policy that will be to the detriment of the bank and to our community.

This is why we are here, to express our very strong belief that the full implications of H.R. 14072 should be reconsidered before taking such an apparently simple but drastic step.

The CHAIRMAN. Thank you very much, Mr. Shea.

Mr. Tisdall.

STATEMENT OF JOSEPH C. TISDALL, EXECUTIVE VICE PRESIDENT, FARMERS BANK OF DELAWARE

Mr. TISDALL. Thank you, Mr. Chairman.

Mr. Chairman and honorable members of the committee, thank you for providing us this chance to be heard before you act any further on reserve requirements for nonmember banks.

I am Joseph C. Tisdall, executive vice president of Farmers Bank of Delaware. It is a State-chartered bank, was established in 1807. Our deposits last week totaled $366 million. Farmers Bank serves the residents, businesses, and governments of the State of Delaware. It is a member of the Delaware Bankers Association; it is not a member of the American Bankers Association, and we don't belong to any other bankers association.

The State of Delaware owns $18 million of the $20 million of our outstanding preferred stock. The Federal Deposit Insurance Corporation owns the other $2 million of our outstanding preferred stock. The State of Delaware also owns 49 percent of the $4,848,000 of common stock outstanding. Combined, the State of Delaware owns 76 percent of the outstanding stock of Farmers Bank. These State-owned shares are voted by an independent statutory commission of seven members. Farmers Bank also has 2,700 other shareholders, most of them residents of the State of Delaware.

Each of the many reserve proposals presented in the past few weeks will impact heavily both on Farmers Bank and on the entire State of Delaware.

As to the State of Delaware, they will remove some $100 million of money from the loan market. Through multiplier effects that first $100 million of loss loans will cause even more lost loans. People to whom banks lend money extend credit in turn; also loans result in additional deposits which create more loans and even more deposits.

Here is a way to describe those losses in everyday terms: $1 million will make approximately 30 average sized home purchase money mortgage loans; $100 million will make 3,000 such loans; $1 million will make 100 average size home improvement loans; $100 million will make 10,000 such loans; $1 million will make 200 average size auto loans; $100 million will make 20,000 such loans.

To those losses must be added the loans and deposits lost by reason of the multiplier effect. Those are huge losses when measured by the Delaware economy.

As to Farmers Bank, the new reserve proposals discriminate against Farmers Bank. First on the basis of size among other commercial banks and, second, between Farmers Bank and some of its very tough thrift competitors.

That discrimination will result in a difference between Farmers Bank and its competitors in their ability to earn profits. The proposed requirements will cause a loss of income, actually a tax; to that tax burden must be added the burden of recent cost increases such as social security, minimum wage and the continuing increases in cost of paperwork and legal advice in dealing with Government regulations. And it goes on and on.

The resulting loss of profits prevents the accumulation of much needed capital at Farmers Bank.

Next, Farmers Bank is a depository for all State of Delaware funds. Those deposits are fully collateralized, largely with U.S. Government obligations. Your reserve proposal will apply to those funds. There is no way to justify such reserves except as a revenue-raising device for the Federal Reserve Bank and the U.S. Government.

Such reserves at 6 percent will cost Farmers Bank between $77,000 per year, at least, and $520,000 per year at most.

What is being considered is a shifting of what Chairman Miller of the Federal Reserve calls a handicap now imposed on relatively few banks. I have no quarrel with that goal, but to stop the shift at $50 million or $100 million, or to apply it only to certain kinds of banks makes no sense to Farmers Bank. It merely handicaps a few more banks, including Farmers Bank of the State of Delaware. It also presents a whole new handicap to the economy of the entire State of Delaware. Please give these problems and the many more created by these reserve proposals a great deal of study before you act and thank you again for the opportunity to be here.

The Chairman. Thank you, Mr. Tisdall.

Now, Mr. Geddes.

STATEMENT OF WILLIAM W. GEDDES, PRESIDENT AND CHIEF EXECUTIVE OFFICER, WILMINGTON TRUST CO., WILMINGTON, DEL.

Mr. Geddes. Thank you, Mr. Chairman.

I am William W. Geddes, president and chief executive officer of Wilmington Trust Co., a State nonmember bank headquartered in Wilmington, Del.

Our total assets are approximately $1,350 million and, in addition, we have a very large trust department.

After over 50 years' membership in the Federal Reserve, on December 7, 1972, our bank resigned. This was done after very careful consideration and deliberation, interviews with our important trust customers as to what difference that would make to them in their attitude toward our bank, our important banking customers, and even I might add a luncheon with David Eastburn of the Federal Reserve in Philadelphia.

The final decision, nonetheless, was to resign from the Fed and at that point we freed up approximately $23 million which had been frozen as reserves up in Philadelphia.

I might say that we have had no adverse criticism over the past 6 years. We have had no need to use the window at the Fed nor do we see any need in the foreseeable future.

We estimate that under the proposed bill it would cost us approximately $2,800,000 before taxes if we were to rejoin the Federal Reserve. As far as what suggestions we might have after looking at this situation—and I am afraid they are not new ones to you, sir,—new Federal Reserve requirements, hopefully to include savings institutions, savings and loans, credit unions and thereby a reduction in the rate of reserve requirements.

Again I appreciate very much being allowed to appear before you. Thank you.

The CHAIRMAN. Thank you, Mr. Geddes.

And now Mr. McConnell.

STATEMENT OF J.H. TYLER McCONNELL, PRESIDENT AND CHIEF EXECUTIVE OFFICER, DELAWARE TRUST CO., WILMINGTON, DEL.

Mr. MCCONNELL. I am Tyler McConnell, president and chief executive officer of Delaware Trust Co. We are a non-Fed member, State-chartered bank with the banking side assets at about $460 million and trust assets of approximately double that.

We thank you for this opportunity to testify on H.R. 14072. It is our judgment that if enacted, this bill would impose extreme and unwarranted burdens upon the citizens of Delaware in general, and upon Delaware Trust Co., its customers, employees, stockholders, and our community in particular.

For example, we estimate that our required reserves would increase from $8.4 million to $21.14 million, based on our current level of deposits. This would have an obviously adverse effect on our bank, but, more importantly, upon the people of our State who frequently depend on our bank for funds as lifeblood for the creation of new jobs and new homes, as well as for the purchase of goods and services. Also, the establishment of these additional reserves could have an unwelcome inflationary effect.

We note with concern that no prices have been set for Federal Reserve services, and that additional funds committed to apparently sterile reserves category under this bill would mean a substantial reduction in credit and services necessary for citizens of our State.

Moreover, increased bank costs occasioned by this bill must, at least in part, be passed on to customers in the form of higher interest rates on loans and increased charges for services. Similar adverse consequences are indicated for other local banks with more than $100 million estimated as being lost to the Delaware economy by passage of this bill. You ladies and gentlemen can appreciate the severe economic loss and adverse effect on jobs which this would have in our small State which is already experiencing the depressing consequences of the exodus from the Northeast to the Sun Belt.

Congress has heretofore steadfastly avoided compulsory Federal Reserve membership, and it seems unwise to overreact in an attempt to cure the Fed's membership problem by mandating requirements which would have the end result of destroying or substantially impairing America's unique dual banking system—the envy of other countries throughout the world. This Nation's correspondent banking system, which has served well for years, would be yet another casualty of the passage of this legislation.

We submit that it is not in the best interest of our country to undertake so drastic an overhaul of the American financial system as would result from the enactment of H.R. 14072. Most of its objectives, in our opinion, can be accomplished under existing law without the detrimental effects of the unduly coercive provisions of this bill. This legislation should not be railroaded through the Congress in the frantic legislative logjam of these preelection weeks. Rather, we would suggest with all humility, Mr. Chairman and ladies and gentlemen, that it would seem wiser, because of its adverse effect on jobs, that this distinguished committee would bring this proposed legislation before the American people at regional hearings.

The Carter administration and this Congress are to be commended for having spent endless hours searching for ways to increase employment in America, a goal with which passage of this bill could be at cross purposes.

Thank you again for your courtesy and for permitting us to testify on this important matter.

The CHAIRMAN. Thank you, Mr. McConnell.

Ms. Lattanzio.

STATEMENT OF ELIZABETH J. LATTANZIO, PRESIDENT AND CHIEF EXECUTIVE OFFICER, FIRST NATIONAL BANK, WILMINGTON, DEL.

Ms. LATTANZIO. I am Elizabeth J. Lattanzio, president and chief executive officer, First National Bank of Wilmington, Del., with $20 million in assets.

I want to thank you for the opportunity to speak out today on the Federal membership legislation. As a representative of a small national bank, I may benefit from the passage of this bill, but I really don't know at this point for two reasons:

The bill was just introduced a short time ago and it was not publicly announced to my knowledge, and there was no time for a meaningful study of impact. We could not do an acceptable job of determination of impact because we do not know the prices we will be required to pay for these services.

We may benefit, but again, we don't know because we don't have the prices.

As a citizen who is interested in banking, I object to a bill which transfers an accepted burden of reserves by all of those who chose to be a member of the Federal Reserve System to the legislative shift of that burden to banks who chose to avoid the membership requirements.

We see the bill as being objectively disruptive, if not destructive, to the dual banking system. It could be discriminatory in that the Fed membership may no longer be voluntary.

We feel Congress should defer further action on this proposed legislation until its probable effects have been accurately identified and thoroughly analyzed.

Thank you, again.

The CHAIRMAN. Thank you, Ms. Lattanzio.

Mr. Boemi, if you will be kind enough, I am going to declare a 5-minute recess so that Mr. Rousselot and I may go over and respond to this recorded vote. So, if you all would be at ease.

Mr. ROUSSELOT. Mr. Chairman, before we go to vote, our distinguished colleague and member of this committee, Tom Evans, asked that we submit for the record a statement from Governor DuPont of Delware on this subject

His statement, as a former Member of Congress, as you know, as to what he feels after careful study, the adverse effect of this would be on the State of Delaware's financial institutions. Congressman Tom Evans would have been here but he was committed to go back to his State before he knew this panel would be here today, many of them from his State. Could I——

The Chairman. You certainly may, and anything written by the Governor and introduced by Congressman Evans is acceptable.

[The statement of Gov. Pierre S. DuPont of Delaware follows:]

STATEMENT BY HON. PIERRE S. DUPONT, GOVERNOR, STATE OF DELAWARE

To: House Committee on Banking, Finance and Urban Affairs.

H.R. 14072, if adopted, would constitute a sweeping change to the U.S. banking structure and could radically alter out present dual banking system. Although I am sympathetic to the goals which the committee is trying to achieve, I have grave reservations about the speed with which this bill is being moved. Because of the magnitude of the changes this legislation would cause, I urge the committee to extend the time period for hearings on the bill to permit further analysis and input by the banking community and to permit further consideration of factors such as (1) the lack of a defined service fee structure, (2) the impact that proposed reserve requirements may have on the balance between demand and time deposits, (3) a requirement that the Federal Reserve pay interest on reserves, (4) exclusion of secured deposits from the base of reversible liabilities, (5) consideration to developing the proper mix of economic incentives to attract increased participation in the Federal Reserve in lieu of coercive measures.

Mr. ROUSSELOT. Thanks to all of you for coming here today to participate in this discussion. The chairman and I promise to come back.

The CHAIRMAN. We will then stand in recess for 5 minutes.

[Recess taken.]

The CHAIRMAN. The committee will be in order.

Thank you all for your patience. I think, Mr. Boemi, we were about to call on you. Would you now proceed?

STATEMENT OF A. ANDREW BOEMI, CHAIRMAN AND PRESIDENT, MADISON BANK & TRUST CO., CHICAGO, ILL.

Mr. BOEMI. Thank you, Mr. Chairman.

My name is A. Andrew Boemi

I am chairman and president of the Madison Bank & Trust Co., in Chicago, Ill., a $90 million deposit State nonmember bank.

I am also chairman of two very new national banks that are affiliated with us.

Mr. Chairman, before I go on, if I may take a second more than you have allotted me, I just wanted to respond to something that you had said relative to the fact that we get a charter to do business and, therefore, we should act in a Godly manner, so to speak.

Well, we do, sir. Next to motherhood and homeownership, we make the loans to business and industry, the banking business does, which creates the jobs that keeps America working. So I just didn't want you to forget that, sir.

The CHAIRMAN. Oh, it is very much in our minds.

Mr. BOEMI. Yes, sir.

The CHAIRMAN. We need you.

Mr. BOEMI. Thank you. I truly deplore the unseeming haste and feverish activity that has developed for the passage of a bill which has such far-reaching consequences. A change in the basic banking structure of this country should be thoroughly thought out.

As a representative of over 500 stockholders and some 40,000 customers, both borrowers and depositors in the Chicago area, we have some very deep concerns.

These are based on the fact that this bill seems to focus on nonmember banks of over $100 million as sacrificial lambs to devise a method of forcing those banks that are members of the Fed to stay in the Fed.

I submit this is not fair or equitable. In all candor, I find it a bit amusing to see some of the members of this committee in bed with our friends at the Bank of America. An unlikely combination.

I recognize that we are not a $100 million deposit bank yet. However, Senator Proxmire's companion bill refers to an $80 million level and Chairman Miller's proposal is for even a lower level of deposits for enforced reserve requirements. If your proposed bill goes into conference, I am not so naive that I don't know what is likely to come out and maybe it is down low enough so that we are in there paying out reserves.

But, aside from the financial implications to our bank which under your current bill are nonexistent, there are some other implications that we consider very important. What are these?

The present banking system provides for voluntary Fed membership. It is philosophic perhaps; it also provides for a dual banking system and gives the Fed, despite their protests, an adequate handle on the monetary system and if statistical reporting is the Fed's problem, let them be our guests; we will provide the same statistics that member banks provide; be glad to do it.

The CHAIRMAN. Not to interrupt, but I note at that point a good many affirmative nods from other members of the panel and, therefore, let me just take this opportunity.

Is there any nonmember bank represented here on the panel—there are a great many nonmember banks on the panel—who would object to being required to furnish the Fed such current statistical information regarding deposits and other money matters as is necessary for the Fed to carry out a sensible monetary policy?

Any nonmember banker here who would object to such a provision, which is like section 1 of the bill before us.

Mr. BOEMI. The truth of the matter is, one more report isn't going to hurt us.

The CHAIRMAN. I note no objection is heard at this point. Please go on.

Mr. Boemi. If the Congress is trying to solve inflation through monetary controls, let me tell you that forcing all $100 million and over nonmember banks into the Fed is not going to solve any inflation; nor is it going to enable the Fed to act on economic change any more rapidly than they do.

Mr. Chairman, it is pointless to blame labor, business, or banks for inflation. The real blame is in the ever-increasing spending that is going on in the Congress and in some instances in State legislatures. And all of it is done in the name of the public good.

Some of the statistics that I have seen show that the final net effect of this proposed bill would be to add many billions of reserve dollars to the economy.

I submit that at this time this, in itself, would be force feeding the inflation engine and I don't see that as a public good.

A voluntary Fed system is best for an independent and free banking system. It gives banks the opportunity to decide for themselves whether or not being a member of the Fed is advantageous for their customers and their stockholders and keep in mind that in the bulk of the banks of this country and all those $100 million or more, their customers are ordinary, retail consumer people.

I believe it would be in the public interest for the Fed and the Congress to make a voluntary system work. Give them the tools to motivate the Fed members to stay in and that will induce nonmembers like ourselves to join.

This I submit is better than the use of dictatorial legislative force to put everyone into a similar mold.

Further, let me state unequivocally that this bill will destroy the dual banking system. If we, as a State-chartered nonmember bank, have to maintain reserves in the Fed in this confiscatory manner, then I can tell you that we and others in our situation will strongly consider conversion to a national charter.

State banking departments will no longer be able to support a bank examination structure without taxing people. I cannot believe that this committee intends to destroy the State banking system.

Mr. DeLay—I found out today he is originally from Illinois—has said, and others have said that certain banks in our category have been enjoying a free ride. This is plain humbug.

There is no such thing as a free lunch in any sector of our economy.

We pay the banks who clear our checks and provide other Fed-type service a fee or balances which are arrived at in a free market and since they normally include a profit in the price of services, we must assume that we do not have a free ride. In fact I know darned well we don't, but we do have freedom, freedom of choice.

Let me add that I am not completely opposed to Fed membership for our bank. If this committee and the Congress would quit worrying about the hidden tax benefit for the Treasury and permitted the Fed to pay a competitive rate for reserve balances along with charging the competitive prices for services, but only necessary services, it is entirely possible that many banks might want to join the Fed on a voluntary basis.

With a 15- to 20-year phasing-in period and with the payment of competitive rates for the use of money, it is quite likely that this will occur. In the 1930's you might recall the Congress gave the savings and loan industry 20 years to phase into their reserve requirements. However, we do not want to give up the freedom of voluntary membership under any circumstances. This is banking's bill of rights; please do not destroy it.

I urge you and members of this committee to reconsider your vote on this bill. Thank you so much for your time.

The CHAIRMAN. Thank you, Mr. Boemi.

Dr. O'Leary.

STATEMENT OF DR. JAMES J. O'LEARY, VICE CHAIRMAN, U.S. TRUST CO., NEW YORK, N.Y.

Dr. O'LEARY. Mr. Chairman, I appreciate this opportunity to appear before you.

Let me say that I think you are doing a great public service in really examining this whole issue of Federal Reserve membership. We all want a strong Federal Reserve System. I think it is an issue that properly needs the sort of examination you are giving it.

I am going to address myself in a limited way to this issue. One of the arguments which has been advanced in support of enactment by Congress in this session of H.R. 14072 is that this legislation is needed on an emergency basis to help insure the Federal Reserve policy can be pursued effectively to curb inflation and to strengthen the dollar in foreign exchange markets.

The question which I shall address then is simply, is there an urgent need for the passage of H.R. 14072 to help insure that the Federal Reserve authorities can conduct monetary policy effectively toward restoring greater stability in the price level and toward strengthening the foreign exchange value of the dollar? Or, alternatively, will postponement of action on H.R. 14072 until the next session of Congress, so that it may receive more mature consideration, insure the ability of the Federal Reserve to deal effectively with the inflation problem and a weak dollar in the foreign exchange markets?

My answer to these questions is that there is not the slightest degree of urgency for the passage of H.R. 14072 to insure the effectiveness of the Federal Reserve in dealing with inflation in the dollar problem. Postponement of action until the next session of Congress will not injure the ability of the Federal Reserve to curb inflation or to defend the dollar in foreign exchange markets.

The fact of the matter is that the monetary authorities already have all the tools and power they need to play a fully effective role toward bringing inflation under control and strengthening the dollar, but they have not been using them effectively until recently. Indeed, there are many respected economists who would argue, not without merit, in my view, that the Federal Reserve has contributed strongly to the high inflation rate and thus to the weakness of the dollar in foreign exchange markets by permitting much too great an increase of the money supply.

I have four charts attached to my testimony. Shown in chart 1 is the monetary base of the United States—member bank reserves at the Federal Reserve banks and currency in circulation—has been permitted by the Federal Reserve authorities to increase at a 9.3-percent rate during the past year. In more recent months it has continued to expand at a seasonally adjusted annual rate of 7.4 to 9.3 percent.

With its present powers, the Federal Reserve authorities have the ability to control the rate of increase of the monetary base and yet they have permitted it to expand at an excessively high rate.

Chart 2 shows, similarly, that during the past 5 years the Federal Reserve authorities have permitted "adjusted Federal Reserve credit"—Federal Reserve holdings of securities, loans, float and other assets—to expand at an 11-percent rate. In recent months the seasonally adjusted annual rate has been in the 6½ to 10 percent range. Given the rapid expansion of the monetary base and Federal Reserve credit, it is hardly surprising that charts 3 and 4 show the high rate of increase in money supply which has occurred in the past 3 years.

The figures today were revised upward so these numbers are on the low side.

In chart 3, M_1—demand deposits plus currency—has been increasing during the past year at a 7.6-percent rate and more recently at about a 6.5-percent rate. In chart 4, M_2—M_1 plus net time deposits—a better measure of money supply, in my view, has been increasing at an 8.4-percent rate during the past year and at 9 to 10 percent seasonally adjusted annual rate in more recent months.

These high rates of monetary expansion have been a major contributor to the high rate of inflation we have been experiencing and thus they have contributed to a weak dollar in foreign exchange markets.

The Federal Reserve authorities already have fully adequate power to reduce the rate of monetary expansion. In my view, they have not sufficiently used the power they already have to effectively curb the rate of monetary expansion. I must say, however, that in recent weeks the monetary authorities seem to be working more effectively to use their powers to reduce the rate of monetary expansion and thus to play their proper role in curbing inflation and helping to strengthen the dollar.

There is nothing in H.R. 14072 which would give the authorities powers that they do not already have to pursue a policy to deal effectively with inflation and the dollar if they have the will and determination to do so.

Therefore, if it is being argued that prompt passage of H.R. 14072 is needed to permit the Federal Reserve to carry out credit policy effectively, there are absolutely no grounds for such an argument. So far as credit policy is concerned, there is plenty of time for careful consideration of H.R. 14072 and no need to rush into a hasty enactment of the bill.

[Dr. O'Leary's prepared statement with attached charts follows:]

Testimony by James J. O'Leary, Vice Chairman and Chief Economist, United States Trust Company, New York, N.Y., Before the Banking, Finance and Urban Affairs Committee of the House of Representatives
September 22, 1978

I am James J. O'Leary, Vice Chairman and Chief Economist of United States Trust Company of New York City. One of the arguments which has been advanced in support of enactment by Congress in this session of H.R. 14072 is that this legislation is needed on an emergency basis to help insure that Federal Reserve policy can be pursued effectively to curb inflation and to strengthen the dollar in foreign exchange markets. The question which I shall address, then, is simply: Is there an urgent need for the passage of H.R. 14072 to help insure that the Federal Reserve authorities can conduct monetary policy effectively toward restoring greater stability in the price level and toward strengthening the foreign exchange value of the dollar? Or alternatively, will postponement of action on H.R. 14072 until the next session of Congress, so that it may receive more mature consideration, injure the ability of the Federal Reserve to deal effectively with the inflation problem and a weak dollar in the foreign exchange markets?

My answer to these questions is that there is not the slightest degree of urgency for the passage of H.R. 14072 to insure the effectiveness of the Federal Reserve in dealing with inflation and the dollar problem. Postponement of action until the next session of Congress will not injure the ability of the Federal Reserve to curb inflation or to defend the dollar in foreign exchange markets.

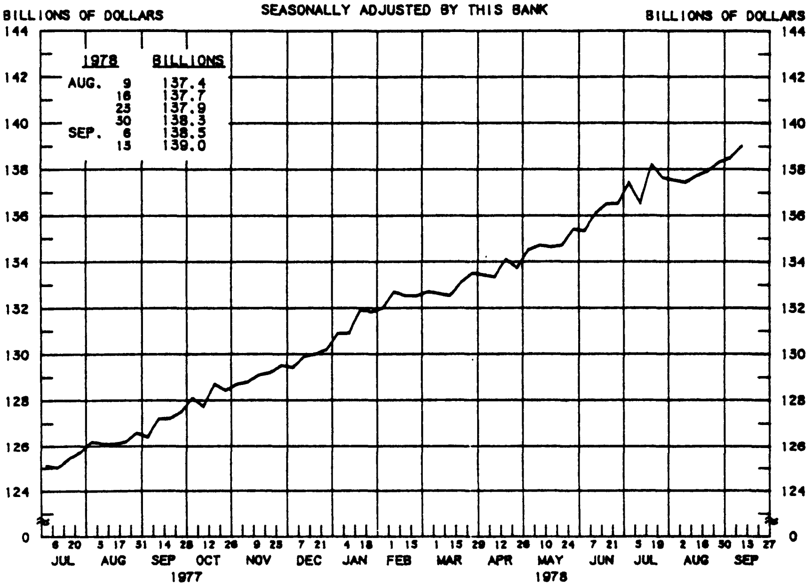
The fact of the matter is that the monetary authorities already have all of the tools and the power they need to play a fully effective role toward bringing inflation under control and strengthening the dollar, but they have not been using them effectively until recently. Indeed, there are many respected economists who would argue, not without merit, that the Federal Reserve has contributed strongly to the high inflation rate and thus to the weakness of the dollar in foreign exchange markets by permitting much too great an increase of the money supply. As shown in Chart 1, the "monetary base" of the U.S. (member bank reserves at the Federal Reserve Banks and currency in circulation) has been permitted by the Federal Reserve authorities to increase at a 9.3 percent rate during the past year. In more recent months it has continued to expand at a seasonally adjusted annual rate of 7.4 - 9.3 percent. With its present powers the Federal Reserve authorities have the ability to control the rate of increase of the monetary base, and yet they have permitted it to expand at an excessively high rate. Chart 2 shows, similarly, that during the past year the Federal Reserve authorities have permitted "adjusted Federal Reserve credit" (Federal Reserve holdings of securities, loans, float, and other assets) to expand at an 11 percent rate. In recent months the seasonally adjusted annual rate has been in the 9 - 10 percent range. Given the rapid expansion of the monetary base and Federal Reserve credit, it is hardly surprising that Charts 3 and 4 show the high rate of increase in money supply which has occurred in the past year.

In Chart 3, M_1 (demand deposits plus currency) has been increasing during the past year at a 7.6 percent rate and more recently at about a 6.5 percent rate. In Chart 4, M_2 (M_1 plus net time deposits) -- a better measure of money supply in my view -- has been increasing at an 8.4 percent rate during the past year and at a 6 1/2-10 percent seasonally adjusted annual rate in more recent months.

These high rates of monetary expansion have been a major contributor to the high rate of inflation we have been experiencing and thus they have contributed to a weak dollar in foreign exchange markets. The Federal Reserve authorities already have fully adequate power to reduce the rate of monetary expansion. In my view, they have not sufficiently used the power they already have to effectively curb the rate of monetary expansion. I must say, however, that in recent weeks the monetary authorities seem to be working more effectively to use their powers to reduce the rate of monetary expansion and thus to play their proper role in curbing inflation and helping to strengthen the dollar. There is nothing in H.R. 14072 which would give the authorities powers that they do not already have to pursue a policy to deal effectively with inflation and the dollar if they have the will and determination to do so. Therefore, if it is being argued that prompt passage of H.R. 14072 is needed to permit the Federal Reserve to carry out credit policy effectively, there are absolutely no grounds for such an argument. So far as credit policy is concerned, there is plenty of time for careful consideration of H.R. 14072 and no need to rush into a hasty enactment of the bill.

Chart 1.

MONETARY BASE
AVERAGES OF DAILY FIGURES
SEASONALLY ADJUSTED BY THIS BANK



LATEST DATA PLOTTED WEEK ENDING: SEPTEMBER 13, 1978

THE MONETARY BASE CONSISTS OF MEMBER BANK RESERVES AT THE FEDERAL RESERVE BANKS AND CURRENCY IN CIRCULATION (CURRENCY HELD BY THE PUBLIC AND IN THE VAULTS OF COMMERCIAL BANKS), ADJUSTED FOR RESERVE REQUIREMENT RATIO CHANGES AND SHIFTS IN THE SAME TYPE OF DEPOSITS BETWEEN BANKS WHERE DIFFERENT RESERVE REQUIREMENT RATIOS APPLY. THE MAJOR SOURCES OF THE MONETARY BASE ARE FEDERAL RESERVE CREDIT AND THE GOLD STOCK. DATA ARE COMPUTED BY THIS BANK. A DETAILED DESCRIPTION OF THE MONETARY BASE IS AVAILABLE FROM THE FEDERAL RESERVE BANK OF ST. LOUIS.

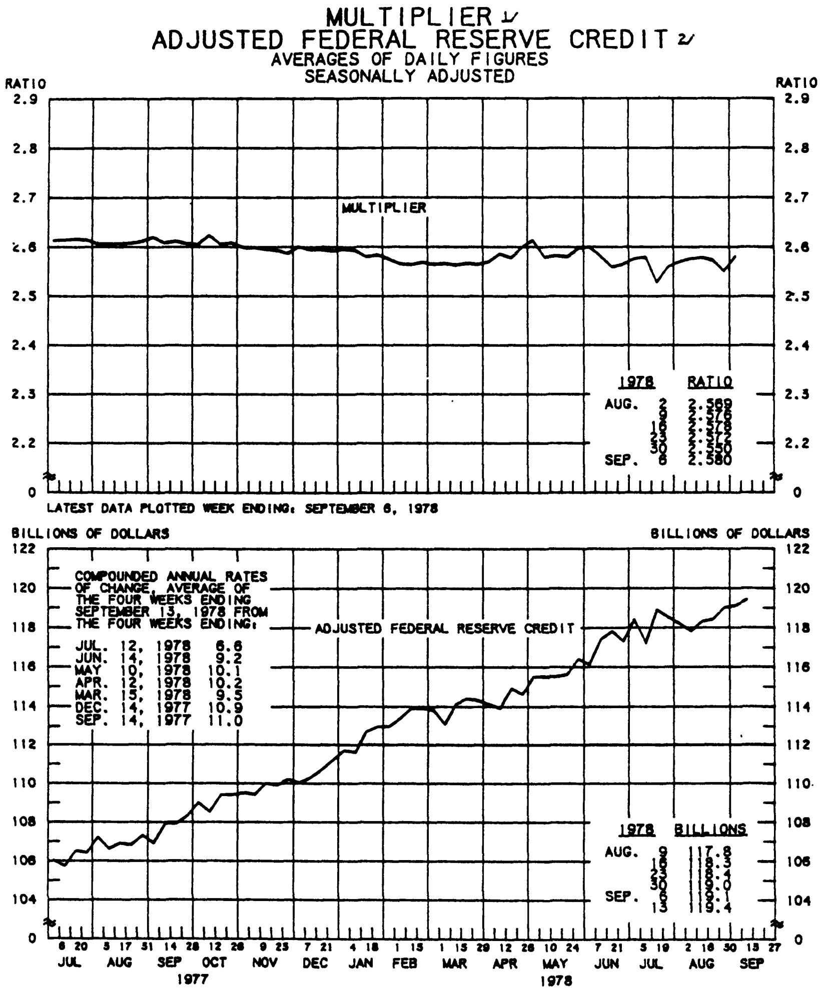
MONETARY BASE

COMPOUNDED ANNUAL RATES OF CHANGE, AVERAGE OF FOUR WEEKS ENDING:

TO THE AVERAGE OF FOUR WEEKS ENDING:	9/14/77	12/14/77	2/15/78	3/15/78	4/12/78	5/10/78	6/14/78	7/12/78
2/15/78	11.0							
3/15/78	9.7	9.9						
4/12/78	9.4	9.2	5.0					
5/10/78	9.5	9.4	6.7	8.6				
6/14/78	9.4	9.3	7.3	8.7	9.5			
7/12/78	9.7	9.8	8.4	9.8	10.6	10.8		
8/16/78	9.4	9.4	8.2	9.1	9.6	9.4	9.8	
9/13/78	9.3	9.3	8.1	8.9	9.3	9.1	9.2	7.4

PREPARED BY FEDERAL RESERVE BANK OF ST. LOUIS

Chart 2.



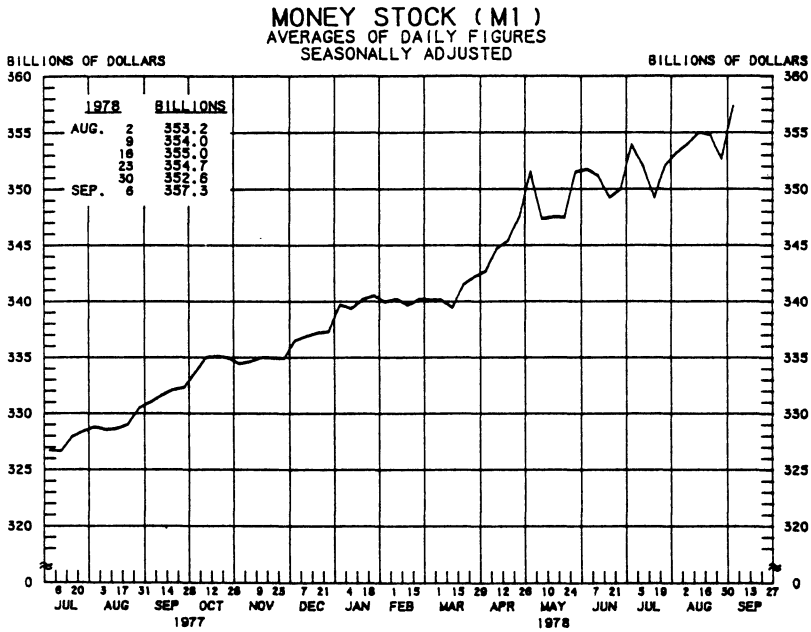
LATEST DATA PLOTTED WEEK ENDING: SEPTEMBER 13, 1978

1/ RATIO OF MONEY STOCK (M1) / MONETARY BASE.

2/ FEDERAL RESERVE CREDIT CONSISTS OF FEDERAL RESERVE HOLDINGS OF SECURITIES, LOANS, FLOAT AND OTHER ASSETS. ADJUSTED FEDERAL RESERVE CREDIT IS COMPUTED BY SUBTRACTING TREASURY DEPOSITS AT FEDERAL RESERVE BANKS FROM THIS SERIES, AND ADJUSTING THE SERIES FOR RESERVE REQUIREMENT RATIO CHANGES AND SHIFTS IN THE SAME TYPE OF DEPOSITS BETWEEN BANKS WHERE DIFFERENT RESERVE REQUIREMENT RATIOS APPLY. DATA ARE COMPUTED BY THIS BANK.

PREPARED BY FEDERAL RESERVE BANK OF ST. LOUIS

Chart 3.



LATEST DATA PLOTTED WEEK ENDING: SEPTEMBER 6, 1978

CURRENT DATA APPEAR IN THE BOARD OF GOVERNORS' H.6 RELEASE.

THE MONEY STOCK CONSISTS OF DEMAND DEPOSITS PLUS CURRENCY AND COIN HELD BY THE NONBANK PUBLIC.

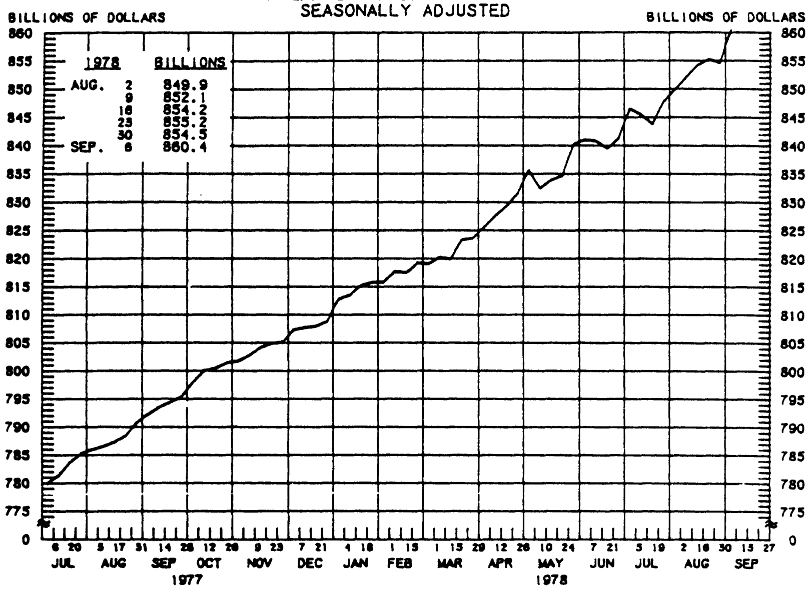
MONEY STOCK (M1)

TO THE AVERAGE OF FOUR WEEKS ENDING:	COMPOUNDED ANNUAL RATES OF CHANGE, AVERAGE OF FOUR WEEKS ENDING: 9/7/77	12/7/77	2/8/78	3/8/78	4/5/78	5/3/78	6/7/78	7/5/78
2/ 8/78	7.6							
3/ 8/78	6.3	5.7						
4/ 5/78	6.2	5.8	2.5					
5/ 3/78	8.2	9.1	9.4	14.8				
6/ 7/78	8.0	8.6	8.6	11.7	14.3			
7/ 5/78	7.9	8.3	8.1	10.3	11.7	6.5		
8/ 9/78	7.3	7.5	7.1	8.6	9.2	5.2	4.4	
9/ 6/78	7.6	7.9	7.6	9.0	9.5	6.5	6.3	6.4

PREPARED BY FEDERAL RESERVE BANK OF ST. LOUIS

Chart 4.

MONEY STOCK PLUS NET TIME DEPOSITS (M2)
AVERAGES OF DAILY FIGURES
SEASONALLY ADJUSTED



LATEST DATA PLOTTED WEEK ENDING: SEPTEMBER 6, 1978

CURRENT DATA APPEAR IN THE BOARD OF GOVERNORS' H.6 RELEASE.

MONEY STOCK PLUS NET TIME DEPOSITS (M2)

COMPOUNDED ANNUAL RATES OF CHANGE, AVERAGE OF FOUR WEEKS ENDING:

TO THE AVERAGE OF FOUR WEEKS ENDING:	9/7/77	12/7/77	2/8/78	3/8/78	4/5/78	5/3/78	6/7/78	7/5/78
2/ 8/78	8.1							
3/ 8/78	7.6	6.9						
4/ 5/78	7.4	6.9	5.7					
5/ 3/78	8.1	8.1	8.2	9.9				
6/ 7/78	8.2	8.1	8.2	9.3	10.5			
7/ 5/78	8.1	8.0	8.0	8.8	9.5	7.9		
8/ 9/78	8.1	8.0	8.1	8.7	9.1	8.0	7.8	
9/ 6/78	8.4	8.5	8.6	9.3	9.7	9.0	9.2	10.1

PREPARED BY FEDERAL RESERVE BANK OF ST. LOUIS

Mr. O'LEARY. I would like to add just a little postscript: If H.R. 14072 were enacted, let us say, in the middle of October and became effective, as I would understand it, say, early in May, it is my understanding that this would release about $14 billion of reserves to the banking system. I understand that the thought is that the Federal Reserve would carry out that reduction over two stages.

Let us say they took $7 billion in May of next year, at a time in which we don't know what the inflationary pressures would be, what interest rates would be. If, let us say, they released reserves, half of those reserves in May of next year, $7 billion, on the basis of the 7-percent reserve requirement, that would mean a potential expansion of bank credit 14 times that $7 billion; or it would mean—it could mean—an increase in money supply of something like 27 percent.

Now, obviously, the Federal Reserve is not going to permit that high a rate of expansion in money to occur. What it would have to be doing, it seems to me, is offsetting that through its open market sales of Government securities; and this would all occur in a time in which we could conceivably have interest rates under upward pressures. So my feeling is that it is incredible to me that at a time in which we have an 11-percent inflation rate, or had it, and have a major problem with inflation, that we are talking about cutting reserve requirements, a potential of $14 billion, opening up the possibility of a major increase in the monetary base at a time in which we have already been letting the monetary base increase too rapidly.

So my own feeling is that this is not only not helpful in making monetary policy more effective but also it is creating a situation which would be potentially dangerous in the spring of next year if it were enacted.

The CHAIRMAN. Thank you very much.

Now L. Glenn Orr, Jr., of Winston-Salem, N.C.

STATEMENT OF L. GLENN ORR, JR., PRESIDENT, FORSYTH BANK & TRUST CO., WINSTON-SALEM, N.C.

Mr. ORR. Thank you, Mr. Chairman. I am L. Glenn Orr, Jr., president of Forsyth Bank & Trust Co., located in Winston-Salem, N.C.

Our institution is a State nonmember community bank. Our bank will shortly celebrate its fifth anniversary and has deposits of approximately $48 million.

I appreciate this opportunity to appear before this committee and to offer a brief statement in opposition to H.R. 14072.

At the outset, let me say that legislation with potential for such a far-reaching impact on the Nation's banking system should be enacted only after the most careful, deliberate consideration. During this period when the economic fiber of our country is under heavy stress, I am certain that the Congress would wish to avoid any confusion, complication or additional burden which might well result from hasty or unneeded, unnecessary action.

The list of well-conceived objections to H.R. 14072 is long. The problems resulting from passage of this legislation in its present form have been thoroughly enumerated by the American Bankers Association. I strongly urge each member of the committee to give close, deliberate consideration to the problem areas that have been pointed out by the ABA.

Specifically, I would address briefly two points in the bill that are most objectionable to me:

One, this legislation would have a negative impact on the Nation's dual banking system. It is my opinion that we have a strong, progressive banking industry in our country today. I believe that this is due in no small measure to the alternatives offered by the present dual banking system. H.R. 14072 would undermine the effectiveness of the dual banking system by removing the option of alternative reserve-setting authority for banks above the specified deposit size limit and by ending the requirement for reserves for national banks below that deposit limit. I believe that this point alone would lead to a dramatic shift to national charters and to a centralized banking system. I strongly believe that this is not in the long-term best interest of our country, our banks or our customers.

My second objection to which I would like to make specific reference is that Fed members under the deposit exemption level, although avoiding reserve requirements, would be called on to pay explicit prices for Fed services and maintain clearing balances with the Fed. For services not offered by the Fed, banks would still have to rely on correspondents.

I find it hard to understand how the impact of this bill can be judged by this committee if the committee does not know the exact services that the Fed will offer and the explicit prices for these services. As a small bank, I have four correspondents competing for our balances, and because of this, I believe that our bank is paying the lowest possible dollar for these required services. This bill would tend to make correspondent bank business for large money centers and regional banks less attractive. It is hard for me to imagine the Fed providing the same level and variety of service, at the same or lower cost, that we now obtain from our correspondents. This will hurt small banks.

In conclusion, let me say that any legislation with such an enormous impact on the Nation's banking system should be well-conceived legislation. I urge each member of this committee to understand all the implications of this bill and to carefully evaluate the many objections which have been raised.

Thank you.

The CHAIRMAN. Thank you, Mr. Orr.

Mr. Holding.

STATEMENT OF LEWIS R. HOLDING, PRESIDENT, FIRST-CITIZENS BANK & TRUST CO., RALEIGH, N.C.

Mr. HOLDING. Mr. Chairman, I am Lewis R. Holding, of Raleigh, N.C., president of the First-Citizens Bank & Trust Co., Raleigh, N.C.

I will at this time confine my remarks to a synopsis of a much more extensive statement that I have filed with the committee and with the reporter.

First-Citizens is a nonmember bank with over $1 billion in assets and 227 branches throughout the State of North Carolina, largely in rural areas. We have an average deposit volume in each office of approximately $4 million.

I strongly oppose H.R. 14072 because of its apparent adverse effect on retail banking and on the continued existence of the dual banking system. Moreover, I am concerned that there has not been time for the exhaustive study necessary for a clear understanding of what all of the ramifications of H.R. 14072 would be; however, a brief analysis of some of the obvious effects of the act on our primarily rural bank and its customers, as well as on the banking system, reveal the following:

First, H.R. 14072 would increase the cost of retail banking to the customers of many rural banks.

Second, H.R. 14072, by tying up additional funds in sterile, non-interest-bearing deposits, would significantly reduce the volume of credit available to many rural bank customers.

Third, H.R. 14072 is inequitable between banks. A small unit bank in a rural community would have no required reserves. A larger bank with a smaller competing branch located in that same community would have to maintain the reserves required by H.R. 14072.

Fourth, H.R. 14072 would constitute a fundamental change in philosophy regarding voluntary membership in the Fed.

Fifth, H.R. 14072 would weaken and destroy the dual banking system and promote the development of a monolithic banking system under one regulator.

Sixth, studies indicate that H.R. 14072 would not provide a basis for more effective monetary control.

These effects of H.R. 14072 are apparent after only brief study. These effects show clearly that the ramifications of enactment of H.R. 14072 would be serious and far-reaching. Moreover, no one, after an opportunity for such a short period of study, can predict what all of these ramifications will be.

Furthermore, H.R. 14072 cannot be intelligently considered in a vacuum. For example, or for instance, the complexities posed by the interaction of the Fed's pricing proposal and the provisions of H.R. 14072 must be fully considered. Thus I join with the American Bankers Association, the Conference of State Bank Supervisors, the former Chairman of the Federal Deposit Insurance Corporation and countless other individuals from every part of the Nation in urging the rejection of the proposals contained in H.R. 14072, and that adequate time be given for the serious study necessary to resolve the problems which it attempts to resolve.

Thank you, sir.

[Mr. Holding's prepared statement follows:]

Statement on

Federal Reserve Act Amendments of 1978

(H.R. 14072)

Presented to

Committee on Banking, Finance, and Urban Affairs
U.S. House of Representatives

by

Lewis R. Holding, President
First-Citizens Bank and Trust Company
Raleigh, North Carolina

September 22, 1978

I am Lewis R. Holding of Raleigh, North Carolina, President of First-Citizens Bank and Trust Company. First-Citizens is a non-member bank with over One Billion Dollars in assets and 227 branches throughout the State of North Carolina--largely in rural areas. I strongly oppose H.R. 14072, the "Federal Reserve Act Amendments of 1978", because of its apparent adverse effect on retail banking, and on the continued existence of the dual banking system. Moreover, I am concerned that there has not been time for the exhaustive study necessary for a clear understanding of what all of the ramifications of H.R. 14072 would be. However, a brief analysis of some of the obvious effects of the Act on our primarily rural bank, First-Citizens, and the customers of First-Citizens, as well as on the banking system, reveal the following:

1. H.R. 14072 would increase the cost of retail banking to the customers of many rural banks.

2. H.R. 14072, by tying up additional funds in sterile, non-interest bearing deposits, would significantly reduce the volume of credit available to many rural bank customers.

3. H.R. 14072 is inequitable between banks. A small unit bank in a rural community would have no required reserves. A larger bank with a smaller competing branch located in that same community would have to maintain the reserves required by H.R. 14072.

4. H.R. 14072 would constitute a fundamental change in philosophy regarding voluntary membership in the Fed.

5. H.R. 14072 would weaken and destroy the dual banking system, and promote the development of a monolithic banking system under one regulator.

6. Studies indicate that H.R. 14072 would not provide a basis for more effective monetary control.

I. INEQUITIES IN THE TREATMENT OF BANKS AND THEIR CUSTOMERS

Section 3 of H.R. 14072 provides equalized reserve requirements which must be maintained with the Fed by member banks and non-member banks alike. This section also provides that "such bank shall be entitled to all the privileges of membership in the Federal Reserve System" with certain exceptions. While these two provisions may at first appear to treat all banks equitably, they in fact magnify competitive disadvantages to the detriemnt of the public and the entire banking system.

A. The Cost To Rural BAnks Of Clearing Checks

First-Citizens Bank, with its 227 largely rural branches, is located in virtually every part of the State of North Carolina. Like many banks, it is forced to rely upon larger correspondent banks for check clearing services. These correspondent banks are Fed members. They maintain required reserves with the Fed, and they clear large volumes of checks through the Fed. Their facilities are located near a Fed Bank, Branch, or check processing center, or their volume allows the cost of transportion of items to the Fed prior to its deadlines.

In out-of-state areas where our correspondent banks have large volume transactions, they can usually clear in one day by direct sendings or using their own correspondents. These correspondents must continually monitor their out-of-state clearings to compare the costs and float factors of sending direct, through correspondents, or through the Fed. Utilization of such correspondent banks is necessary for rural banks more distant from the Fed in order to participate in these various methods of clearing items. We must carry large compensating balances with our correspondent banks to pay for these services.

A bank which is not located near a Fed Bank, Branch, or check processing center, particularly a bank with a relatively small volume of checks, because of the constraints of transportion and computer costs, cannot meet the Fed's deadlines without the use of correspondent banks. Such a rural bank experiences a significant competitive disadvantage. The costs which it incurs in clearing checks must ultimately be borne by its customers. Thus, our bank must constantly strive for the most efficient and least expensive methods of clearing checks. Outside meddling in these internal banking operations can only result in inefficiencies and higher costs.

B. Increased Costs Borne By Retail Customers Of Rural Banks

The reserves which First-Citizens is required to maintain by State law and regulation are maintained with its correspondent banks, which perform many of the check clearing functions which the Fed performs directly for its member banks. If enacted, H.R. 14072 would require First-Citizens to maintain reserves with the Fed. However, in order to clear checks from its rural and low-volume branches, it would continue to be necessary for it to maintain substantial non-interest bearing reserves in its correspondent banks, resulting in a large overall increase in its sterile, non-interest bearing reserves. First-Citizens and other banks in rural areas which utilize such correspondent banks serve primarily retail banking customers. Their costs of doing business must be passed on to their customers. Thus, the net effect of H.R. 14072 would be to redistribute the costs of the Federal Reserve System, with an increased share of those costs being borne by retail banking customers.

C. Reduced Credit Available To Retail Customers Of Rural Banks.

The customers of our rural branches include farmers, small merchants, and other individuals who are relatively small depositors and borrowers. Such retail bank customers do not exercise the kind of economic leverage or have access to the multiple sources of credit utilized by large corporations. Rather, they depend upon their local bank as their source of credit.

H.R. 14072 would tie up a large additional amount of rural banks' funds in sterile, non-interest bearing deposits. A

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direct and immediate effect of sterilizing such additional funds of rural banks would be to substantially reduce and deny the credit which these banks are able to make available to their rural, retail customers.

II. DISCRIMINATION BETWEEN LARGE AND SMALL BANKS

With both an increased share of the cost of the Federal Reserve System and with the cost of correspondent check clearing services being borne by retail banking customers of rural banks, the inequities arising between banks due to H.R. 14072 become apparent. Moreover, H.R. 14072 would set reserves for all banks with over $100 million in reservable liabilities at a 6% level, and at a zero level for smaller banks.

Thus, under the provisions of H.R. 14072, many small unit banks in rural communities would have no reserve requirement. Our bank maintains competing branches in those same rural communities. However, our bank would be required by H.R. 14072 to maintain reserves with the Fed not required of our competitors. The enactment of such a concept would constitute blatant discrimination against larger banks, and would unnecessarily create a competitive disadvantage in numerous communities between them and smaller banks and thrift institutions without the 6% reserve requirement of H.R. 14072.

III. H.R. 14072 ENCOMPASSES A FUNDAMENTAL CHANGE IN PHILOSOPHY REGARDING VOLUNTARY MEMBERSHIP IN THE FED

The implications of enactment of H.R. 14072 cannot be limited to increased costs to the public, reduction in credit available to retail borrowers, and the creation of additional competitive disadvantages. Rather, H.R. 14072 encompasses a fundamental change in the philosophy of voluntary membership in the Fed. To compel non-member banks to maintain reserves with the Fed is tantamount to bringing about compulsory membership in it.

The Federal Reserve System was designed in 1913 pursuant to a philosophy that control of credit should not be centralized, and that any centralized authority should be subject to checks and balances. The structure of the Federal Reserve System, with its twelve district banks and voluntary membership, has reflected this philosophy from 1913 to the present day. First-Citizens Bank, along with the American Bankers Association, has always supported the independence of the Fed. We believe that voluntary Fed membership is essential to that independence.

Without the preservation of the voluntary membership concept, one of the most important of the checks and balances which protect private institutions against the abuse of a centralized authority would be eliminated. These private institutions would inevitably seek relief from perceived abuses through the use of the political process, leading to greater potential control over the Fed. This could diminish the effectiveness of monetary policy.

Moreover, I fear that such a politicized Federal Reserve System would lead to politically inspired attempts to influence the allocation of credit. The efficiency and innovativeness with which the private sector allocates resources would ultimately be diminished--to the detriment of the standard of living of all.

IV. H.R. 14072 WILL WEAKEN AND DESTROY THE DUAL BANKING SYSTEM

The banking system of the United States has developed within the federal character of our state and national governments. This is manifested in the ability of both the states and the federal government to charter banks and other depository institutions. The vitality of this dualism is maintained by permitting banks to convert from one chartering authority to another. This dual system of state and national banks has been a positive element in the American system of government and has contributed to the innovation and responsiveness found in our financial system. Accordingly, maintaining a balance between the State and national banking systems is a desirable public policy. Despite the decline of Federal Reserve membership, member banks still hold approximately three-quarters of domestic deposits. Moreover, the largest banks which depend on Federal Reserve clearing and money transfer services represent a hard core of membership and deposits not likely to leave the Federal Reserve System.

No one can state with assurance that the uniform reserve affiliation with the Fed mandated by H.R. 14072 would not lead many non-members to obtain national charters. In fact, authorities have predicted that numerous, larger non-member banks required to maintain reserves with the Fed would obtain national charters because of factors including the following: (1) a preference for one examiner--the Comptroller of the Currency, instead of two--the State and the FDIC; (2) to obtain privileges not available to state-chartered banks; and, (3) a desire to use the title "national" bank.

A substantial conversion of the larger state-chartered non-member banks to national charters could significantly reduce assessments and examination fees that now support state banking departments in a number of states. As of 31 December 1977, of the total 14,707 banks in the United States, 10,053 were state-chartered. Of these, only 310, or 3.1 percent were non-members with over $100 million in deposits. However, the 310 larger non-members held more than 18 percent of all state-chartered bank deposits. Moreover, the over $100 million deposit non-member banks in the District of Columbia and the forty-nine states excluding the State of New York held approximately 24 percent of total state-chartered bank deposits. Furthermore, under H.R. 14072, non-member banks with under $100 million in "reservable liabilities" would also be induced to obtain national charters in order to avoid required reserves set by their states.

George A. LeMaistre, former Chairman of the Federal Deposit Insurance Corporation, expressed the concern of many bankers over the threat to the dual banking system when he testified before this Committee on August 4, 1978 regarding H.R. 12706, the Federal Reserve Membership Act of 1978. Mr. LeMaistre stated:

> Universal reserve requirements are perceived as a threat to the integrity of State banking systems. If non-member banks have to maintain reserves at the Federal Reserve just as member banks must do, but have no access or have limited access to the discount window and other System benefits, why not become members? The assumption is that obligatory universal reserves would not only make non-membership unattractive, but many institutions would also be inclined to convert to a national charter. The result would be an imbalance in the dual system in favor of membership in the national banking system. (Emphasis added)

V. H.R. 14072 IS NOT NEEDED FOR EFFECTIVE MONETARY CONTROL

The Federal Reserve System perceives a problem of declining membership. The percentage of total deposits of commercial banks held by Federal Reserve members has decreased from 83 percent in 1965 to approximately 73 percent at the present time. The Fed has stated its belief that the decline in the proportion of deposits held by its member banks adversely affects the precision with which monetary policy can be conducted. However, I disagree that the uniform reserve requirements mandated by H.R. 14072 would provide a basis for more effective monetary control.

There have been several studies of the monetary control issue by economists which have concluded that increased Fed membership is not important to the effectiveness of monetary policy. Some of these studies were referred to by FDIC Chairman George A. LeMaistre when he testified before the Committee on August 4, 1978 regarding H.R. 12706, the Federal Reserve Membership Act of 1978. Chairman LeMaistre's testimony regarding these studies is as follows:

> There have been two major statistical studies which attempted to ascertain the impact of uniform reserve requirements for nonmember banks on the implementation of monetary policy. The first was conducted by Clark Warburton for the Commission on Money and Credit. Warburton concluded that nonmember banks are affected by Federal Reserve monetary policy actions in approximately the same way that member banks are. Another investigation was reported by Dennis Starleaf of Iowa State University. In Starleaf's study the actual M_1 money multiplier for the period 1962-1972 was compared with a money multiplier series simulated under the assumption that all banks were subject to the reserve requirements of the Federal Reserve. The

simulation indicated that had nonmember banks been subject to such reserve requirements there would have been even greater variations in the money stock. Starleaf thus rejected the argument that uniform Federal Reserve reserve requirements are necessary for the implementation of monetary policy.

There have also been a number of articles that attempted to analyze the logical arguments and the statistical data that exist on this issue. The Hunt Commission concluded that "reserve requirements are unnecessary for open market operations to control the monetary base effectively." Carter Golembe, after discussing the difficulties in conducting monetary policy with precision, concluded that,

> ... so many factors contribute to the lack of precision and certainty that simply changing the proportion of deposits subject to Federal Reserve requirements from almost 80 percent to nearly 100 percent would be of relatively minor importance.

In a 1974 study, Professors Ross Robertson and Almarin Phillips investigated the argument that nonmember banks behave in a different manner from member banks and that such behavior thwarts implementation of Federal Reserve monetary policy. They concluded that these arguments have no validity:

> This contention deluded those who are innocent of money matters and even a few who should know better. As has been observed, open market operations are for all practical purposes the instrument of monetary control. Like the rain from heaven that falls on us all, regardless of our merits, open market operations affect member and nonmember banks alike. There is not one shred of evidence to the contrary.

A study conducted by Gary Gilbert and Manferd Peterson at the FDIC found results similar to those of Robertson and Phillips. They concluded that,

> ...the behavior of nonmember banks under varying degrees of monetary ease or restraint is relatively similar to that of country member banks. To the extent that systematic behavior of the demand deposits components is important for the effective control of the money supply, there is no indication from available evidence that the nonmember banking segment has hampered monetary policy.

Some economists have stressed the caveat that the Federal Reserve could control monetary aggregates without member banks or without reserve requirements. For example, in a 1973 article Henry and Mable Wallich stated that,

> Since intermediation [the function of gathering funds from various entities and lending them to others] is a constructive activity, there seems to be no reason why Congress should place burdens upon it beyond those that the tax system imposes on any other form of business. The bulk of commercial banking has been exposed to a special tax, in the form of reserve requirements. It makes no essential difference that the revenues from the tax reach the Treasury via the Federal Reserve. There is no particular reason for this tax, since the Federal Reserve can quite well conduct monetary policy operations without required reserves. The requirements could, then, be phased out to give full effect to the benefits of intermediation.

Most economists regard reserve requirements as secondary to open market operations in conducting monetary policy. The Federal Reserve has made minimal use of changes in reserve requirements in recent years, in part owing to its fear of aggravating the membership attrition problem. Nonetheless, the limited use of this monetary tool has not had a noticeable impact on the ability of the Federal Reserve to conduct monetary policy.

Furthermore, several studies have shown that open market operations have a timely impact on all commercial bank reserves. These studies indicate that the total impact is felt by banks in some regions within the first 2 weeks following the open market operations. In most cases, the impact of open market operations on reserves is transmitted within 6 weeks. Moreover, the length of time for the impact of open market operations to be transmitted is not related to the region's distance from money market centers.

Chairman Lemaistre concluded, "In summary, we believe the need of legal reserve requirements for monetary control purposes is not supported by the weight of available evidence. The evidence to date suggests that monetary policy effectiveness depends on adequate data, proper estimation procedures and appropriate open market operations decisions, and not on reserve requirement jurisdiction." (Emphasis added).

The CHAIRMAN. Thank you sir.
Mr. Craig.

STATEMENT OF BEN T. CRAIG, CHAIRMAN, NORTHWESTERN FINANCIAL CORP., NORTH WILKESBORO, N.C.

Mr. CRAIG. Thank you, Mr. Chairman.

My name is Ben T. Craig. I am chairman of Northwestern Financial Corp., located in North Wilkesboro, N.C. Our bank is a $1.3 billion bank serving medium-sized cities and small towns in western North Carolina, with 180 offices.

I would like to summarize my institution's position on the bill, H.R. 14072.

Northwestern Bank is one of the nonmember State-chartered banks which would be adversely affected by the passage of this bill in its present form. This is certainly one of the reasons I am here today, as I am sure you can appreciate; however, this is one of those happy occasions when the relatively narrow interests of an individual company coincide with those of its industry and, more importantly, to the public good.

It is our position that this legislation, as presently constructed, has the potential for doing considerable harm to the Nation's banking system and most especially to the system of dual banking which has contributed enormously to the vitality and competitiveness of banking in this country.

On the other hand, the stated benefits of the proposed legislation have not been sufficiently quantified in terms of the impact on monetary policy or the stated revenues from the Fed's proposed direct sale of correspondent banking services.

In short, I believe additional information and additional study is required before such sweeping legislation is enacted by the Congress. I therefore urge that the legislation be deferred until such time as it can be evaluated in a more thoughtful and comprehensive manner.

Our specific objection to this legislation is its potentially severe, negative impact on State banking in North Carolina. The North Carolina banking market has long been one of the most competitive banking environments in the United States in terms of branch expansion and product competition. In part, I feel this is the direct result of the aggressive and healthy competition which the dual banking system provides in our State.

The appendix to my paper shows in a dramatic way the potential for harm to the dual banking system in North Carolina. The nine largest nonmember North Carolina banks, all of which would be negatively affected under all three versions of H.R. 14072, had a combined total of $4.05 billion in deposits at the end of 1977. At the same date, the 61 total North Carolina State banks had total deposits of $5.26 billion.

In short, these nine banks hold 77 percent of the total deposits in the North Carolina State banking system. In the event these nine banks, by virtue of being required to maintain reserves with the Federal Reserve, were to convert to national banking charters, more than three-fourths of the State's State banking system deposits would disappear. This would certainly cripple and probably doom our dual banking system.

Thank you very much, Mr. Chairman.

[Mr. Craig's prepared statement follows:]

STATEMENT BY

BEN T. CRAIG
Chairman
Northwestern Financial Corporation
North Wilkesboro, North Carolina

To The

U. S. House of Representatives

Committee on Banking, Housing, and Urban Affairs

September 22, 1978

Among the bankers appearing before this Committee in regard to H.R. 14072, one of the most frequently mentioned objections to the bill will probably be the seeming haste with which the Congress is attempting to restructure the nation's banking industry via what Chairman Reuss himself considers to be "the most important monetary banking legislation since the 1930's", according to the Wall Street Journal. It is precisely the Committee's recognition of this widespread feeling among bankers that has offered us the opportunity of being here today, for which opportunity I would like to personally thank the Chairman and the Committee.

A related source of concern in this sweeping legislation is the fact that it is being considered on the basis of incomplete information. This situation is analogous to that of trying to put a jigsaw puzzle together when many of the pieces are missing. However, what we are dealing with here is not a jigsaw puzzle, but the basic financial structure of the United States. I strongly urge this legislation to be deferred until it can be given the comprehensive evaluation I feel is urgently needed.

The effects of the bill on the federally-mandated reserve levels of certain member and nonmember banks are listed in the bill in admirably complete detail. However, other crucially important information is noticeably absent from the bill and, hence, absent from the consideration of this Committee.

Specifically, there is no indication of what prices the Federal Reserve Board plans to charge for each of the specific banking services it offers. Pricing of banking services is of course the key element in the nation's well-developed correspondent banking system, with its well-known benefits to smaller banking institutions and their customers. This bill, among other defects, possesses the appearance of intending to federalize the correspondent banking business and, for that matter, the entire banking industry.

Quite interestingly, while the Federal Reserve Board was apparently unable to analyze the situation thoroughly enough in the time available to unveil a price list for its services, an estimate was made of the revenues the Fed would capture once its services are priced and available to the market. As a businessman, I frankly fail to understand how this estimate was produced. How can you estimate a company's sales if you don't know it's unit product prices? If a publicly-held corporation were to engage in this type of exercise, it would probably receive a call from the S.E.C. rather quickly.

One other thought-provoking point relates to the Fed's intention to now compete directly with commercial banks in offering correspondent banking services. In a recent survey conducted by Greenwich Research Associates, users of correspondent bank services were asked to rate the Fed against commercial banks in eight specific banking services. With the exception of two of these services, the user banks' majority opinion was that commercial banks offer better quality services at a more competitive price level than does the Fed. Recognizing that this is only an informed opinion, it tends to further cloud the bill's estimate of total Federal Reserve revenues which will be derived from the sale of correspondent services.

One of the stated purposes of H.R. 14072 is to help the Fed "improve the conduct of monetary policy". And yet, nowhere in the bill do I see any figures or estimates as to what the bill will specifically accomplish in this regard. The omission of data in this connection is most disturbing.

Another objective of the bill is to "help solve the Federal Reserve's membership problem". There is considerable evidence which tends to suggest this might be accomplished by instituting a much smaller average reduction in reserve requirements for Federal Reserve members than the approximately 20% cut contemplated in this bill. In addition, this could be accomplished with relative ease and without the arbitrary and negative impact this bill would have on nonmember banks of a certain deposit size and structure.

When a responsible attempt is made to place a value on the correspondent balances held by Federal Reserve Board member banks, it becomes clear that the differential cost between Fed membership and nonmembership narrows appreciably from that generally quoted without considering such balances. This factor apparently has not been considered in H.R. 14072 either. In short, there is a very real possibility that this legislation may in effect be trying to kill a fly with a bulldozer.

I am concerned also with what I view as the arbitrary tax this bill would levy on nonmember banks of a certain size level. I view the imposition of federally-mandated reserve requirements on some nonmember banks as a "tax" because it would not provide any tangible benefits to these institutions--it would not pay for correspondent banking services, nor would it entitle these banks to Federal Reserve membership. I view it as "arbitrary" since it would not be based on profit, or gross income or real property, but solely on size as measured in terms of deposits.

This proposed legislation is additionally alarming to me because of the potentially severe negative impact it could have on this nation's dual banking system. The dual banking system not only provides banks with a degree of freedom of choice, which after all is one of the tenets upon which this country was founded, but it is also in my opinion largely responsible for the high degree of innovation and competitiveness which is one of our banking industry's most admired characteristics around the world.

By simply adding up the impact by state on those nonmember banks which would be required to maintain reserves with the Federal Reserve for the first time in history, the unevenness with which the various states are affected becomes readily apparent. This, I believe, is another indication of the basically arbitrary, almost random nature of the proposed changes.

The effects on the North Carolina banking industry in particular could be potentially horrendous insofar as our state's dual banking system is concerned. Incidentally, you may know that the North Carolina banking market has long been one of the most competitive banking environments in the United States in terms of branch expansion and product competition. In good part, I feel, this is a direct result of the aggressive and healthy atmosphere which the dual banking system provides in our state.

The appendix to this paper shows in a dramatic way the potential for harm to the dual banking system in North Carolina. The nine largest nonmember North Carolina banks (all of which would be negatively affected under all three versions of H.R. 14072) had a combined total of $4.05 billion in deposits at the end of 1977. At the same date, the 62 total North Carolina state banks had total deposits of $5.26 billion. In short, these nine banks hold 77.0% of the total deposits in North Carolina's state banking system. In the event these nine banks, by virtue of being required to maintain reserves with the Federal Reserve, were to convert to national banking charters, more than three-fourths of North Carolina's state banking system deposits would disappear. This would certainly cripple and probably doom our dual banking system.

Finally, as the Committee recognizes, I have not come here today entirely out of altruism. My institution will be among those hurt by this legislation, and I am naturally not happy about this prospect.

Passage of H.R. 14072 would require my institution to maintain an additional $20 to $30 million in sterile reserves. Moreover, we would have to continue paying for correspondent services, whether from the Fed or from commercial member banks. The additional reserves alone would represent a reduction in our earning asset base in the range of 1 ½% to 2 ½% and would have a significant negative effect on our earnings. This in turn would most likely impact our pricing of consumer services and our longer-range plans in regard to such considerations as branch expansion and new product development.

I would again like to thank both Chairman Reuss and this Committee for the opportunity of presenting my views on this vitally important matter.

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APPENDIX TO STATEMENT OF
BEN T. CRAIG
NORTHWESTERN FINANCIAL CORPORATION
NINE LARGEST N. C. NONMEMBER BANKS
FIGURES IN MILLIONS AS OF 12/31/77

	@12/31/77 Total Deposits	(A) Effect on Reserves HR 13847 Appendix I	(B) Board Amendments (No Adjustment for Affiliate Groups) Appendix II	(C) House Committee Alternative Appendix III
Central Carolina Bk. & Trust (Durham)	$ 365.7	$ -14.5	$ -15.9	$ -12.2
American Bk. & Trust (Monroe)	200.2	- 4.9	- 6.3	- 3.6
Northwestern Bank (N. Wilkesboro)	1,172.0	-60.3	-50.3	-52.9
First Citizens Bk. & Trust (Raleigh)	1,072.2	-52.4	-54.1	-51.4
Peoples Bk. & Trust (Rocky Mount)	264.4	- 9.1	-10.7	- 7.7
Security Bk. & Trust (Salisbury)	127.7	- 1.4	- 4.7	- 2.2
Carolina Bank (Sanford)	123.8	- 1.1	- 3.9	- 1.5
Waccamaw Bk. & Trust (Whiteville)	263.5	- 9.3	- 9.5	- 6.7
Branch Banking & Trust (Wilson)	455.6	-19.3	-23.0	-18.2
Nine Bank Totals	$ 4,045.1	$ -172.2	$-178.4	$-156.7
All 62 State Banks	$ 5,256.3			

77.0% OF TOTAL STATE NONMEMBER BANK DEPOSITS

The CHAIRMAN. Thank you, Mr. Craig.
Mr. McNair.

STATEMENT OF JOHN McNAIR III, VICE CHAIRMAN, WACHOVIA BANK & TRUST CO., N.A., WINSTON-SALEM, N.C.

Mr. McNAIR. Thank you, Mr. Chairman. I am John McNair III, vice chairman of Wachovia Bank & Trust Co., N.A., Winston-Salem, N.C.

Wachovia is a $3.75 billion bank. We have 186 branches across our State. I am grateful to you for the privilege of appearing today to testify on legislation under consideration to facilitate the implementation of monetary policy and to promote competitive equality among commercial banks. As we have examined H.R. 14072, we have been pleased to note that it is the sense of the committee to initiate legislation that will lower reserve requirements for most member banks of the Federal Reserve System.

The lost opportunity cost for lending or investing these reserves has, in our opinion, been a major factor in the erosion of membership in the Federal Reserve System. These lost opportunity costs have more than offset the value of services provided by the Federal Reserve for most member banks.

Additionally, the membership problem has been further amplified by policies which have given access to certain Federal Reserve services to both nonmember banks and nonbank financial institutions at no explicit cost or costs in the form of reserves.

We have submitted an 8-page document that speaks to each section of H.R. 14072. Our verbal testimony will be brief.

Section 3 of the bill, recently voted affirmatively on by a majority of this committee, would do radical surgery on the dual banking system that has served so well the financial needs of our Nation for many, many years.

The existence of two systems for banks has given banks the choice to affiliate with the system which best accommodates the needs of each bank and the marketplace it serves. It has allowed for innovation and experimentation in new service ideas. The dual system of regulation has allowed these institutions to be more responsive to the needs of their marketplace as opposed to a centralized and more rigid Federal system.

The time could be at hand when there is reason to reexamine the merits of the dual banking system to determine if it can continue to successfully serve the citizens of our Nation. Any study should be deliberate and thorough and legislation should be promulgated only after the results of such study have been carefully weighed.

Obviously, there have been changes in the living patterns, the lending patterns, as well as the banking patterns, of our citizens in the last two generations. This may well point to a need for a change in the structure of our banking system. If such a determination is made, however, the changes should be addressed in a forthright manner and not made a part of legislation which has other expressed purposes.

As an officer of a national bank which, at least on the surface, would benefit by the passage of H.R. 14072, it might seem strange to you that I ask that the question be studied further; however, before joining Wachovia more than 10 years ago I served as president of a small State-regulated, nonmember bank. From that, I can strongly endorse the merits of the dual banking system for smaller, hometown banks.

The legislation we are discussing today can have far and, at this point in time, unmeasurable repercussions. It is not clear that the beneficial effects of H.R. 14072 outweigh its possible adverse implications for the Nation's financial systems and for the public interest. There is a delicate balance in the domestic, and especially in the international money markets that could be easily upset by dramatic changes such as those proposed.

These do not appear to be the times during which to hastily make fundamental changes in a system which, with all its imperfections, has well served the public interest through both difficult and prosperous times. Refinements are badly needed to improve efficiency and equity but they should be made only after careful and deliberate appraisal of immediate and long-range effects.

Mr. Chairman, I appreciate the opportunity to offer these observations for consideration by the distinguished members of your committee.

I have 16 letters with me from other bankers in North Carolina and I would like to ask your indulgence that they be entered in the record.

The CHAIRMAN. Without objection, they will be entered in full in the record immediately following your prepared statement.

Mr. McNAIR. Thank you, sir.

[Mr. McNair's prepared statement and the 16 letters from bankers in North Carolina, referred to above, follow:]

John F. McNair III, Vice Chairman
WACHOVIA BANK & TRUST COMPANY, N. A.
Winston-Salem, North Carolina
Before the
Committee on Banking, Finance & Urban Affairs
United States House of Representatives
September 22, 1978

Congressman Reuss and members of the Committee, I am John F. McNair III, Vice Chairman of Wachovia Bank & Trust Company, N. A., Winston-Salem, North Carolina.

I am grateful for the privilege of appearing before you today to testify on the legislation which you are considering to facilitate the implementation of monetary policy and to promote competitive equality among commercial banks. In our examination of H. R. 14072, I am pleased to note that it is the sense of this Committee to initiate legislation that will lower reserve requirements for most member banks of the Federal Reserve System.

It is our opinion that a major factor in the erosion of membership in the Federal Reserve System has been the heavy burden of reserves which member banks have been forced to shoulder. The lost opportunity cost for lending or investing these reserves has more than offset the value of services provided by the Federal Reserve to most member banks.

In addition, the membership problem has been further amplified by policies which have given access to certain Federal Reserve services to both non-member banks and non-bank financial institutions at no explicit charge or cost in the form of reserves.

It is clear to us that the solution of the Fed's membership problem is inherent in these two policy areas. I will set forth our ideas as to the resolution of these issues at the conclusion of my testimony.

To proceed with an orderly examination of the major elements extant in H. R. 14072, I will pose four questions and proceed to analyze them in light of our reading of the proposed legislation.

To begin, we must ask what the impact of this legislation will be on the conduct of monetary policy by the Federal Reserve. We note and support the Fed's apparent suggestion that monetary policy can be effectively implemented with a lower overall level of reserves. We also support Section 2 of H. R. 14072 that would require all depository institutions to furnish appropriate financial information to the Federal Reserve to aid its role of monitoring and controlling monetary and credit aggregates. In this regard, we would ask only that the reporting requirements be designed in such a way as to limit the additional reporting workload on financial institutions.

Our second broad area of inquiry concerns the distributive effects of the proposed legislation on important structural elements of the U. S. banking system. Our banking system has evolved over the years an infrastructure which successfully serves the demands of our individual and corporate citizens alike, and we must use great care in contemplating major surgery on what appears to us to be a very healthy patient.

Of significant concern to us is Section 3 of H. R. 14072. The proposed language would require reserves of all banks, but through an exemption provision remove the reserve requirement burden from the vast majority of U. S. banks. As many state banking systems require reserves of their members in one form or another, the prospect of no reserves could provide a strong incentive for smaller banks to abandon their state chartered non-member status.

It is important to remember that a hallmark of America's banking tradition has been the state supervision of these smaller banks that serve the banking needs of the medium and small cities and towns that are the backbone of America. The close supervision and influence of state banking departments has been critical in ensuring that a banking system exists which is responsive to serving these needs.

While not denying that some larger banks serve many of these same markets, it is fair to note that a thrust of larger banks has also been to serve the larger needs of the corporate marketplace regionally, nationally and internationally. The supervision and influence provided by regulation at the Federal level has been more in tune to the needs of these institutions, and, as a result, many of them have chosen affiliation with federal regulators.

The dual system of supervision and influence has worked effectively and does not require the radical surgery contemplated in H. R. 14072.

The existence of two systems has also given banks the choice to affiliate with that system which might best accommodate, indeed encourage, experimentation in new service ideas. And it has permitted bank affiliation with that system which evolved overall regulation most sensitive to the needs of each individual bank's public.

The dual system has provided for the smaller bank a system of regulation which allows these institutions to be more responsive to the needs of their marketplace as opposed to being one of thousands of banks regulated by a Federal authority.

One other possible side effect of the proposed legislation could be to impact the ability of small banks to maintain adequate liquidity to meet unexpected runoff in deposits and increases in loans. The current system of reserves that exists in most states serves as a constant reminder to bank managers that safety and liquidity are important elements in the operation of their banks.

To guard against possible overreaction in this respect, the national bank regulators could be forced to impose stronger secondary reserve requirements than might be necessary. The result of such a practice would be to reduce the ability of these banks to serve their customers and markets.

Another important element in the evolution of America's current and most successful banking structure is our payments system. Among the most sophisticated in the world, it owes its success to both Federal Reserve and the private banking system's initiative and investment. To meet the increasingly complex financial servicing needs of this nation, the continued evolution of an optimum payments system is an important goal.

In this regard, it is important that incentives exist for the private sector to make appropriate contributions to this process. One potential element in ensuring this development is provided by the call for the explicit pricing of Federal Reserve services in a competitive fashion as set forth in Section 9 of H. R. 14072.

We support fully the majority of the principles set forth in this section. However, there are four elements that concern us and deserve comment.

The first is that the bill calls for publication of pricing schedules and principles no later than July 1, 1979. We feel that it would be helpful to focus on this significant change by setting a definite date for implementation of pricing schedules as well.

Our second concern is the inequity in cost which will exist for those banks permitted to access Fed services. While all will be charged the same explicit price, the larger banks will also have to bear the opportunity cost of required reserves. This cost inequity will distort the volume flows through the Fed and thus contribute to the evolution of a less than optimum payments system. This inequity can be corrected by requiring similar reserve requirements and explicit prices for all users of Fed services and by paying reserve holding banks a fair market rate of interest on their required reserves.

A third concern is that H. R. 14072 does not speak to certain of the non-pricing techniques which the Fed can utilize to capture payments system volume. Examples of these powers are the Fed's ability to manage cutoff times at relay points and RCPC's and the Fed's ability to grant artificial as opposed to actual availabilities in their check clearing programs.

A fourth and crucial caveat is the escape mechanism on pricing provided to the Fed in Section 9(c)(3) which sets forth the principles of Fed pricing, but then states, "...except where the Board determines that the public interest requires a departure from this principle, after giving due regard to competitive factors and the provision of an adequate level of services nationwide."

This language makes it possible for the Fed to be the final arbiter of the future shape of the payments system rather than allowing a marketplace directed by the forces of competitive pricing to be the final determinant.

Another important structural area of banking to be impacted by H. R. 14072 is the correspondent banking system. The main threat is the authority given the Fed to dominate the payments system. In addition the reserve requirement proposals would eliminate a traditional source of correspondent bank funds as the banking system becomes more national in character.

It is important to note the correspondent system's role in the smooth functioning of the American banking system. It is through this vital network that credit is smoothly allocated from surplus markets to deficit fund markets. In addition, due to the existence of profitable relationships, larger correspondents are willing to provide individualized management consulting services to smaller banks.

Without the raw material provided by correspondent relationships, the future availability of funds could be constricted and the price of providing credit increased. The regulatory process could also be burdened as the incentive for self-help among banks is reduced.

The final distributive effect of this proposed legislation we wish to address is the question of whether it contributes to the process of allowing all financial institutions to compete in a fair and equitable manner.

H. R. 14072 will certainly promote some competitive equality among those banks not subject to reserves and other financial institutions not currently burdened with the opportunity costs of reserves. However, it is our feeling that some level of reserves in the banking system is required for effective implementation of monetary policy, and we feel that those reserves should be shared equally in terms of uniform reserve requirements by all member banks. In turn, those banks should have access to Federal Reserve services and non-member and non-bank financial institutions which seek such access should do so either through a member bank or be willing to maintain the same level of reserves as member institutions.

In this regard, legislation permitting non-bank financial institutions to join the Fed should be enacted. Further, to the extent that members or non-members willing to post the reserves necessary to access Fed services are required to pay explicit prices, then they should be paid a fair rate on their reserves to reflect their true opportunity costs.

In closing, we would suggest that your Committee and the Congress proceed cautiously and consider carefully the likely impact of the major elements of H. R. 14072 concerning reserve requirements, access and the pricing of services. The interrelationship of these elements are most complex and could portend grave consequences for this nation's banking system and consumers. It also strikes us that the studies recommended in Sections 6, 7 and 8 might best be concluded and analyzed before the enactment of any legislation. In addition, the Committee could well benefit from studies that are now being conducted in the private sector.

In the meantime, if the Federal Reserve's membership problem has indeed reached serious proportions, we would suggest a tool is currently available to the Fed. This tool does not conflict with their current view of reserve requirements as they relate to the conduct of monetary policy. Current legislative reserve requirement ranges give the Fed substantial room to reduce the opportunity cost of membership and hence increase its attractiveness. This could be achieved through a lowering of reserve requirements.

In conjunction with a plan to reduce reserve requirements, an additional incentive to membership could be offered by a redistribution of the Treasury Tax and Loan account on the basis of each member bank's pro rata share of total required reserves.

Assuming uniform reserve requirements, the Tax and Loan accounts could be distributed on an equitable basis among member banks and once again be returned to their useful role as a shock absorber between required reserves and open market operations. Non-member banks, which have enjoyed Treasury Tax and Loan balances at the expense of members, would have an additional incentive to join the Fed. In addition, the Fed would be able to implement monetary policy in a somewhat smoother fashion with TT&L balances residing primarily in the banking system rather than in the U. S. Treasury account at the Fed.

While Congressional action would probably be required to implement such a move, this is an idea which should also receive rigorous study by the Fed, the Treasury, and the Congress.

In summary, it is not clear that the beneficial effects of H. R. 14072 outweigh its possible adverse implications for the nation's financial system and for the public interest. There is a delicate balance in the domestic and, especially, in the international money markets that could easily be upset by dramatic changes such as those proposed.

The wounds inflicted on this system by the experience of 1974 have not yet completely healed. Further, the economic and monetary systems of the U. S. and the world continue to be buffeted by the effects of foreign energy dependence, budgetary deficits, currency revaluation and inflation.

These do not appear to be times during which to hastily make fundamental changes in a system which, with all its imperfections, has well served the public interest through both difficult and prosperous times. Refinements are indeed badly needed to improve efficiency and equity, but they should be made only after a careful and deliberate appraisal of immediate and long-range effects.

Mr. Chairman, I appreciate the opportunity to offer these observations for consideration by the distinguished members of your Committee.

State of North Carolina
Department of the Treasurer

HARLAN E. BOYLES
STATE TREASURER

325 N. SALISBURY STREET
RALEIGH, NORTH CAROLINA 27611

September 20, 1978

Congressman Stephen L. Neal
House of Representatives
331 Cannon House Office Building
Washington, D. C. 20515

Dear Congressman Neal:

It gives me great pleasure to hand to you, by the kind offices of John McNair, a copy of the resolution which was passed today by the North Carolina Banking Commission, in support of the concept of a dual banking system.

The vote in favor of this resolution, I might note, was unanimous. As the resolution speaks for itself, I will not add to it, but I stand ready to comment further at any time you might desire me to do so.

Sincerely,

Harlan

Harlan E. Boyles
State Treasurer

Enclosure: Resolution - September 20, 1978

The Department of State Treasurer includes Local Government Commission, Teachers' and State Employees' Retirement System, Local Governmental Employees' Retirement System, Public Employees' Social Security Agency, Legislative Retirement Fund, Escheats Fund, and Tax Review Board.

RESOLUTION

WHEREAS, The Banking Commission of the State of North Carolina is charged with the regulation of state-chartered banks in the public interest, and

WHEREAS, the system of state and national banks has demonstrated the desirability of the dual banking system to enhance the role of banking in the public interest, and

WHEREAS, certain bills now pending in the Congress of the United States, if enacted into law, would impair the viability of the dual banking system, inasmuch as forced Federal Reserve membership by numerous state-chartered banks would likely cause these banks to seek national charters as a practical matter, thus reducing the number of state-chartered banks in North Carolina and elsewhere, and

WHEREAS in the public interest, and in order to preserve the dual banking system and the concept of voluntary membership in the Federal Reserve System, it appears that further study and hearings are indicated for these far-reaching proposals.

NOW, THEREFORE BE IT RESOLVED, thet the North Carolina Banking Commission strongly reaffirms its support of the preservation of the dual banking system in the public interest and opposes adoption of the pending legislative bills that would erode this long-established concept and respectfully requests the members of the Congress of the United States to delay action on these proposals to the end that further study and extensive hearings can be held and that a copy of this resolution be transmitted to each member of the North Carolina Congressional Delegation.

September 20, 1978

Yadkin Valley Bank
AND TRUST COMPANY

September 20, 1978

The Honorable Stephen L. Neal
House of Representatives
331 Cannon House Office Building
Washington, D. C. 20510

Dear Mr. Neal:

The purpose of this letter is to express my opinion on the House Banking Committee's hasty approval last week of Bill H. R. 14072. There is no question that legislative changes in the reserve requirements are necessary. However, staggering uncertainties have been raised by this bill and especially by the unprecedented action by the House Banking Committee voting on this bill without the benefit of any public hearings. I am pleased to learn that Chairman Reuss will allow several bankers to officer comments on September 22.

My bank is not directly affected by this bill because I am not a member of the Fed and I do not have 100 million in deposits. However, I do feel very strongly that approval of this bill would have a drastic effect on the dual banking system in our country. Government is again taking away the free choice by which a bank now decides whether it will be a member or non-member by making Fed membership a requirement under certain conditions through this legislation.

Secondly, small banks make up the largest group of banks in the country. I consider myself a small banker and I depend heavily on my correspondent banks to give me the back-up and support I need to give good banking service to my customers. This bill would have a tremendous cost effect in my correspondent's pricing of services to me. I think that this bill would have a serious effect on the North Carolina Banking Community because it will effect the State Banking Commission by state chartered banks switching their charters to national charters in order to fix for themselves a more equitable position.

32-972 1620

110 WEST MARKET ST. • TELEPHONE (919) 835-2626 • POST OFFICE BOX 1006 • ELKIN, NORTH CAROLINA 28621

I am sure that you will review the ramifications of this bill in the best interests of banks and especially its effect on North Carolina banks. I urge you to oppose this bill in its present from.

Sincerely yours,

W S Tayloe Jr

W. S. Tayloe, Jr.
President

Commercial & Farmers' Bank Established 1906/Member Federal Deposit Insurance Corporation

K. L. Kiger, President

September 21, 1978

Honorable Stephen L. Neal
Member of Congress
331 Cannon House Office Building
Washington, D. C. 20510

Dear Congressman Neal:

I would like to take this opportunity to express my strong opposition of Bill HR 14072. It concerns me as to whether this Bill and its far reaching effects have been adequately studied.

In my opinion this Bill, as proposed, is far reaching and would greatly change the balance between our state and federal systems and should be very seriously considered over a longer period before being made law. It is also my opinion passage of this Bill would declare an end to our dual banking system and State Banking Commissions.

I take this opportunity to urge you to do all in your power to get proper consideration of HR 14072 before this Bill is made law.

Sincerely,

K. L. Kiger

K. L. Kiger
President

Rural Hall, N.C. 27045/Stanleyville Office/Expressway Office, Highway 65 at U.S. 52/(919) 969-5571

32-972 O - 78 - 47

Cape Fear Bank
& TRUST COMPANY
P. O. Box 1809
Fayetteville, North Carolina 28302
(919) 483-1121

September 20, 1978

The Honorable Stephen L. Neal
331 Cannon House Office Building
Washington, D. C. 20515

Dear Congressman Neal:

I would like to express my strong opposition to H.R. 14072. The many objections to this legislation have been enumerated by the American Bankers Association and I totally support the ABA's position. Legislation, with such a great potential for impact on the banking system, should be enacted only after the most careful study of the implication. I do not feel that this matter has been adequately studied. Also, I am very concerned about the possible adverse effect H. R. 14072 might have on the nations' dual banking system.

I urge you to do all in your power to see that this matter gets the proper consideration by the Congress.

Sincerely yours,

Benjamin A. Wilson, Jr.
President

BB&T BRANCH BANKING AND TRUST COMPANY WILSON, NORTH CAROLINA 27893

THORNE GREGORY
PRESIDENT

September 20, 1978

The Honorable Stephen L. Neal
Congress of the United States
House of Representatives
Washington, D. C. 20515

Dear Congressman Neal:

I am writing to voice my concern about H. R. 13847 which would require banks of a certain size to carry reserves with the Fed whether they are members or not. This seems to me to be a radical departure from our time-tested dual system which has worked so well for so many years. This bill could do severe damage to the dual banking system, and especially in our State. Present large non-Fed members such as our bank, Northwestern, First-Citizens, Waccamaw Bank and Trust, and Peoples Bank and Trust may very well switch to national charters if they are forced to hold reserves with the Fed. If in fact these banks did elect to switch to a national charter, it would severely cripple, if not destroy, our State Banking Department because in all probability it would wither from lack of revenue. Should this occur, I can foresee more and more financial strength and power gravitating toward Washington forming an all powerful national bank system which would increasingly become subject to pressures of centralized government.

Another concern is that the bill would cause capital to go out of North Carolina and your district to the Fed in the form of sterile reserves. This is money which could be used productively here in North Carolina, which has traditionally been a capital short state.

A third consideration and certainly one that is not unimportant from my point of view, is that the bill would have a substantially negative impact on the earnings of this bank and of the others which are affected.

In my opinion, this whole shift in philosophy has extremely broad implications and it should be given most careful consideration.

I hope you will give this matter serious thought and will do what you can to insure that the bill does not pass before it has been given ample hearing.

With kindest regards,

Sincerely,

Thomas Gregory

President

LEXINGTON STATE BANK
LEXINGTON, NORTH CAROLINA 27292
September 20, 1978

The Honorable Stephen L. Neal
331 Cannon House Office Building
Washington, DC 20510

Dear Mr. Neal:

We, in the banking industry, are very much concerned with the action considered in connection with Reserves Against Deposit Accounts.

It is my understanding that there will be hearings on House Bill 14072 Friday afternoon and we do hope that you will see fit, using your usual good judgment, to oppose this bill.

Sincerely,

Haynes F. Sherron
President

HIGH POINT BANK AND TRUST COMPANY
INCORPORATED 1905
POST OFFICE BOX 2276
HIGH POINT, NORTH CAROLINA
27261

FRED W. ALEXANDER
PRESIDENT

September 20, 1978

Honorable Stephen Neal,
House of Representatives,
Washington, D. C.

Dear Steve:

The purpose of this letter is to voice our opposition to H. R. 14072. This bill, as you know, would require all banks with over $100 million in deposits to keep their required reserves with Federal Reserve. This is certainly an undercover method to require the banks eventually to join the Federal Reserve system and further regulate the already highly over regulated banking business.

If the bill is passed, it will be a mockery for State chartered banks and the dual banking system. Not only would the bill (which I believe would be unconstitutional) force the banks to join the Fed, but many would convert from State chartered banks to National banks which again would weaken the dual banking system.

We strongly urge you to use all the power of your office and to solicit any help from other House members to rise up and defeat the unwarranted action which is being thrust upon the American people and the banking system by the Russ bill.

Respectfully yours,

Fred Alexander

President

THE CAROLINA BANK

Post Office Drawer 1380
Sanford, NC 27330
September 20, 1978

Representative Stephen L. Neal
502 Cannon House Office Building
Washington, DC 20515

RE: Amendments to the Federal Reserve Act Bank Reserve Requirements

Dear Congressman Neal:

We would like for you to oppose this legislation which will affect state chartered banks. We believe that requiring reserves to be held at the Federal Reserve Bank would be detrimental to the dual banking system. If mandatory reserves at the Federal Reserve Bank are imposed, it will cause the banks to become members of the Federal Reserve System and only those small banks with the proper deposit mix will remain to provide competition between banks. There are numerous other reasons that we are requesting that you oppose this bill, but we will not detail them at this time.

Again, please permit the dual banking system to continue which has served this country well for many years.

Sincerely yours,

Ted B. Lanier

Ted B. Lanier
President

PEOPLES BANK OF NORTH CAROLINA
MADISON, NORTH CAROLINA 27025

September 21, 1978

The Honorable Stephen Neal
House of Representatives
Washington, D. C.

Re: Fed. Membership Bill
HR 14072

Dear Steve:

This letter is to show our opposition to H R 14072. We believe that if this bill is enacted that it will have an adverse effect on our dual banking systems. This bill would create pressure on small banks to join the Federal Reserve system.

We strongly urge you to oppose this piece of legislation and we hope that congress will study this piece of legislation more thoroughly before it is inacted.

Sincerely yours,

Joe I. Marshall
President

Mechanics and Farmers Bank

116 WEST PARRISH STREET, P. O. BOX 1932, DURHAM, NORTH CAROLINA 27702

September 20, 1978

The Honorable Stephen L. Neal
The House of Representatives
Washington, D. C.

Dear Mr. Neal:

There is a bill pending in the Congress that, in my opinion, would impair the dual banking system that we now have.

I feel strongly that it is in the public interest that we maintain the concept of voluntary membership in the Federal Reserve System and the State Banking System.

I hope you will use your influence to see that action on this bill is delayed so that further study and hearings can be held before the important concept of a dual banking system is changed.

Sincerely,

J. J. Sansom, Jr.

J. J. Sansom, Jr.
President

Waccamaw
A UNITED CAROLINA BANK
ucb

September 20, 1978

The Honorable Stephen L. Neal
United State House of Representation
Washington, D. C. 20515

Dear Congressman Neal:

Bill Adams of Monroe and I appreciated our visit with you last week to discuss Chairman Reuss' bill which would require state non-member banks to be subject to reserve requirements of the Federal Reserve Board. I would like to list our objections to the bill:

1. The proposed legislation is a major one for the banking industry and yet it is being rushed to the floor of Congress without any detail study of its effect. We fail to see anything in the present financial world that is so urgent that the bill be considered before a proper study has been made.

2. The bill will definitely be damaging to the dual system of banking. Certainly all banks effected will begin a study as to whether to remain as non-member state chartered or join the Federal Reserve. It is our belief that a large majority will switch. These banks, although few in number related to the total number of banks, hold a large portion of the deposits in many states.

3. The sterilizing of reserves (approximately $9,000,000 less cash in vault in our case) will reduce loanable funds for all the banks covered by the bill.

4. The bill should certainly be delayed until the Federal Reserve has completed its pricing of its services.

In view of the above we sincerely hope the committee will reject immediate consideration of this bill.

Sincerely yours,

Lawrence W. Bowers

Lawrence W. Bowers
Chairman of the Board

AROLINA 28472 (919) 642 5131

CCB
CENTRAL CAROLINA BANK

W.L. Burns, Jr.
President

September 20, 1978

The Honorable Stephen L. Neal
331 Cannon House Office Building
Washington, D. C. 20510

Dear Congressman Neal:

We are delighted that Chairman Reuss of the House Banking Committee has allowed banks to appear before your Committee regarding House Bill 14072. We feel that the way this bill was handled - without the proper input from our banks - was extremely high-handed, and I just hope that the hearings will be meaningful and objective.

We oppose this legislation because we think that it has some serious implications of undermining the dual banking system in this country. To have the Federal Reserve in complete control of all banking, under the guise that it is the only way they can guarantee adequate monetary policy, seems inconsistent to me.

In addition, the Federal Reserve Bank of Richmond cannot offer us competitive services to those we are presently receiving from our correspondent banks for the reserves that would be required to keep with them. Unfortunately, the Federal Reserve Bank in Charlotte is not geographically well located for North Carolina. There recently was established a branch in Columbia, South Carolina, that can more adequately serve the banks in that state. We would be forced to carry our work to Charlotte, which is a three-and-a-half hour drive from Durham, whereas at the present time we can get our work into our correspondent in Raleigh by 11:30 p.m. for clearance the next day. The Federal Reserve cannot offer this service at present, and before they should force us into carrying reserves, they should be competitive.

We feel that we should not be forced into paying for services we will not receive and that some definite understanding should be determined regarding the dual banking system and its continuing need to serve this country.

I hope you will continue to oppose this legislation.

Yours sincerely,

WL Burns

W. L. Burns, Jr.

Post Office Box 931, Durham, North Carolina 27702, 919/682-9111

INDEPENDENCE
NATIONAL
BANK

POST OFFICE BOX 1776
GASTONIA, NORTH CAROLINA 28052
704/867-1851

September 20, 1978

Honorable Stephen L. Neal
House of Representatives
331 Common House Office Building
Washington, D. C. 20510

Dear Representative Neal:

I understand a hearing will be held this Friday on the proposed Federal Reserve Uniform Reserves Bill. Needless to say, this proposed legislation will effect the banking industry and ultimately the consumer in many direct and indirect ways.

Our Bank has been a National Bank and, therefore, a member of the Federal Reserve throughout its history and I am a former Director of the Federal Reserve Bank of Richmond. The matter of bank reserves is a very complicated one and the effect of substantial changes as proposed will seriously impact all banks, some favorably and some unfavorably. It is my opinion that this matter should be given considerably more study before action of any kind is taken. I know it is unnecessary to comment to you on such unresolved subjects as pricing services, etc. which also get involved.

I hope your Committee will seriously consider postponing definite action at this time. I feel that the present system of keeping reserves at the Federal Reserve places an undue burden on member banks and needs revision in the interest of fairness, but I do not think it should be done based on studies now available.

Thank you for your consideration.

Sincerely yours,

Plato Pearson Jr

Plato Pearson, Jr.
President

PIEDMONT BANK
AND TRUST COMPANY

September 20, 1978

The Honorable Stephen L. Neal
House of Representatives
Washington, D. C. 20515

Re: HR 14072 -- Required Reserves With Fed

Dear Mr. Neal:

I am writing to express my strenuous disapproval of this bill, which would foster further power in the hands of federal regulatory agencies.

This bill is unnecessary and unfair to smaller and medium sized banks, particularly State banks outside the Federal Reserve System. Passage of this bill will be another step in shifting the balance of power between the states and the federal government and will tend to erode further our dual banking system.

It is unfortunate that I, as chief executive officer of this bank, spend an inordinate amount of time in the completely non-productive business of fighting off various forms of encroachment by government regulatory agencies.

Thank you for your consideration.

Sincerely,

John A. Tate, Jr.

John A. Tate, Jr.
President

P. O. BOX 38, DAVIDSON, NORTH CAROLINA 28036 · 704/892-8861

PHONE 704/735-0431

CAROLINA FIRST NATIONAL BANK Drawer 520 · Lincolnton, North Carolina 28092

A. G. THOMPSON
PRESIDENT

September 20, 1978

The Honorable Stephen L. Neal
House of Representatives
502 Cannon House Office Building
Washington, D. C. 20515

Dear Congressman Neal:

I am concerned over the possibilities of the passage of the pending Reuss Bill (HR 14072). Due to the obvious uncertainties raised by this Bill, I urge you to oppose it and seek to have this legislation deferred until its probable effects have been accurately identified and thoroughly analyzed by all concerned parties. There appears to be a number of potentially harmful effects to our present viable dual banking system.

Your opposition to HR 14072 is urged.

Respectfully yours,

A. G. Thompson

A. G. Thompson

Bank of North Carolina

September 20, 1978

The Honorable Stephen Neal
331 Cannon House Office Building
Washington, D. C. 20510

Re: HR 14072

Dear Representative Neal:

We understand that the above-mentioned bill has been reported out of the Banking, Finance and Urban Affairs Committee and that hearings are going to be held shortly in connection with the bill.

We would like to go on record as strongly supporting the American Bankers Association's position in opposition to the bill. The matters addressed in the bill need to be studied more thoroughly and careful consideration should be given to its effect on the dual banking system as it now exists.

Your consideration of this matter will be greatly appreciated.

Sincerely,

Charles F. Merrill
Executive Vice President

P. O. Box 18868 • Raleigh, North Carolina 27609 • (919) 782-6710

The Bank of Asheville
Box 1881, Asheville, North Carolina 28802
Area Code 704/252-3841

JAMES W. G. WOOLLCOTT
CHAIRMAN OF THE BOARD
AND PRESIDENT

September 20, 1978

The Honorable Stephen L. Neal
331 Cannon House Office Building
Washington, D. C. 20510

Dear Mr. Neal:

I write in opposition to HR 14072. I strongly urge that considerable more time be allowed for those affected by the bill to give their views. Because of the increasing bank regulatory power concentrated in Washington, the dual banking system in this country is in what I would describe as fragile condition already. I think the passage of this legislation would weaken it further.

I do not regard the relatively small percent loss of membership that the Federal Reserve system has experienced over the last several years would significantly impair its ability to do its job of regulating money supply. To this extent, the Fed has been less than effective in this role - it might better be attributed to errors in judgment.

Respectfully,

James Woollcott

James Woollcott
Chairman and President

The CHAIRMAN. Now, Dr. Charles F. Haywood, of Lexington, Ky.

STATEMENT OF DR. CHARLES F. HAYWOOD, VICE CHAIRMAN OF THE BOARD OF DIRECTORS, BANK OF LEXINGTON, LEXINGTON, KY.

Dr. HAYWOOD. Mr. Chairman, I appreciate the opportunity to be here today.

I ask that my prepared statement be made a part of the record.

I am a professor of finance at the University of Kentucky and an economic consultant.

I am here, however, today in my capacity as vice chairman of the board of directors of the Bank of Lexington, Lexington, Ky.

In my prepared statement I have described why the Bank of Lexington, which is a nonmember bank with $68 million in deposits, would shortly become subject to H.R. 14072. One reason is that the bank is a depository for city tax collections and that before the end of December our savings and demand deposits will exceed $75 million, at least for a few days.

The bill is not clear about how such a short-term swing would be treated, but that really isn't the basis for our concern with this issue.

The Bank of Lexington is only 12 years old. It today is five times what is was 6 years ago in size. It has grown very rapidly. So it is only a matter of perhaps another year or two or three before it would come under the requirements of H.R. 14072. Being a bank that would grow—that is growing faster than the average the escalation provisions of the bill mean very little to us.

What we find is this, that our average required reserve ratio under State law as of the middle of 1978, taking our June 30 figures, was 4.7 percent. Under H.R. 14072 the average ratio would be 5.1 percent, so that on each additional dollar of deposits we would have to hold higher reserves under H.R. 14072.

I am ignoring the exemption levels for the moment.

One of the reasons why the average ratio under H.R. 14072 is higher for us than the State law is because of the higher reserve requirement on savings accounts. Under State law we have a 3 percent reserve requirement on savings accounts and this bill would impose 7 percent.

We think that might have been inspired, it seems it could at least have been inspired, by some of our savings and loan competition because what that will do to us, in effect, is nullify or at least make it more difficult for us to compete on savings accounts when they become automatic transfer accounts.

In other words, the elimination of the interest differential is in a sense being offset by this additional reserve requirement for us. So one of the things that concerns us here is competition in this automatic transfer area. Anything that would increase the relative importance of our savings accounts as we expect the automatic transfer arrangement to do, would result in a greater disparity between the State ratio and H.R. 14072, thus increasing the burden of reserve requirements.

Now, on this question of the exemption levels, we really don't see much value to the exemption levels when we go above the $50 million mark.

The reason is that our cash balances are used by us as working balances and we are going to need working balances, whatever reserve system prevails. When we come under Federal Reserve requirements on the amounts in excess of the exemption levels, those balances will have to be held as idle funds. Due to the pass-through requirements we would not expect our correspondent bank to give us credit for those. We think we receive very good services from our correspondent, not just on financial items, but in many managerial ways, kinds of services that we think the Federal Reserve would not be able to provide. If we are required to maintain balances at the Federal Reserve, we would still need working balances at our correspondent bank.

So we regard this bill as imposing additional reserve requirements on us rather than releasing us from any need to hold cash that we now have.

We are very sensitive to this problem because, while we have been a very rapidly growing bank, we also have been a bank that has had a problem about earnings. We have had to, in effect, buy our way into this market. It is a market dominated by a large bank that holds 50 percent of the market. We have engaged in aggressive branching, advertising, pricing of our services, and Saturday banking hours, and all that costs money.

At the same time, we have had low earnings and rapid growth. The result of that is that we have a capital problem. We are going to have to go out and sell additional stock within the next few months. I would have to say that in our statement about the prospects for our bank we would have to say the effect of H.R. 14072 would be adverse in terms of disclosure to potential purchasers. In terms of our earnings margin, it is not a a relatively insignificant amount.

I go into more detail on this in my written statement. I would like to take the remaining moment here, Mr. Chairman, to pick up on a comment made by my colleague in the economics business, Dr. O'Leary, about the problem that would be posed by the release of $7 billion to $14 billion, whatever the sum is, in reserves, some time in the next year.

I think that the prospect that such reserves would be released in the system could be very adverse to the international value of the dollar. One reason is that there would be uncertainty about what the effect of the released reserves would be.

If the Federal Reserve was unsuccessful or people thought the Federal Reserve would be unsuccessful in mopping up these excess reserves and that the inflation rate might be accelerated, then we would see a further loss of confidence in the dollar at the time when that confidence is not very high anyway.

If the Federal Reserve were successful in mopping up these excess reserves, and in the past it has not shown it was confident that it could handle this big an adjustment, but if the Federal Reserve were successful, then the result would be a sharp increase in interest rates. I think that sharp increase in interest rates would have very adverse effects on credit markets, particularly the housing market.

[Dr. Haywood's prepared statement follows:]

STATEMENT ON H. R. 14072
by
CHARLES F. HAYWOOD, VICE CHAIRMAN, BANK OF LEXINGTON, KENTUCKY
to the
HOUSE COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS
September 22, 1978

My name is Charles F. Haywood. I am a professor of finance at the University of Kentucky and an economic consultant. I am here today, however, in my capacity as vice chairman of the board of directors of the Bank of Lexington, Lexington, Kentucky.

The Bank of Lexington, a state-chartered bank, is not a member of the Federal Reserve System. The Bank of Lexington commenced operations in 1966. On June 30, 1978 the bank's total assets were $67.8 million. We think that is pretty good growth for a 12-year old bank. Moreover, much of the growth has been achieved within the past six years, as the bank's total assets were only about $12 million at mid-1972.

We expect that before the end of this calendar year the total assets of Bank of Lexington will exceed $100 million. Unhappily, that notable achievement will last for only a few days or so. It will reflect the fact that we are a depository for local property-tax collections, and at year-end the collected funds will be transferred to disbursement accounts at other banks.

As the tax collections are paid into our bank, our demand and savings deposits will increase from $41 million at June 30, 1978 to about $75 million. We will thus temporarily swing across the line where a non-member bank, under H. R. 14072, becomes subject to the reserve requirements of the Federal Reserve System. We are uncertain about how a swing of this type would be treated under H. R. 14072.

Our concern with H. R. 14072, however, is somewhat more substantial than how a short-term swing in deposits might be treated. Excluding tax collections, we expect our demand and savings deposits to exceed $50 million by, perhaps, mid-1979, probably by year-end 1979, and almost certainly before mid-1980. Our time deposits, which were $22.3 million at mid-1978, will probably exceed $50 million within three to four years. The prospect, therefore, is that Bank of Lexington would need to meet the required reserve ratios of the Federal Reserve within one to two years on demand and savings deposits and three to four years on time deposits. Escalation of the exemption levels, as provided in H. R. 14072, might lengthen these periods by a year or two, but as the Bank of Lexington is growing more rapidly than the average bank, the day of reckoning with the Federal Reserve would not be long in coming.

On June 30, 1978 the average required reserve ratio of the Bank of Lexington, under state law, was 4.7 per cent. Ignoring, for the moment, the exemption levels under H. R. 14072, the average required ratio would have been 5.1 per cent based on the initial ratios provided in H. R. 14072. These averages reflect, of course, the composition of our deposits on June 30, 1978. A relative increase in the importance of savings deposits, which we expect to occur after automatic transfers become effective in November, would tend to decrease the average ratio under state law and increase the average ratio under H. R. 14072. The reason is that savings deposits are subject to a reserve ratio of only three per cent under state law compared to seven per cent under H. R. 14072.

When the exemption levels are taken into account, the average required reserve ratio under H. R. 14072 would, of course, be less than the current average ratio under state law. However, for each dollar of growth in deposits beyond the exemption levels the average required ratio under H. R. 14072 would exceed the average ratio under state law. Moreover, at the present time we can use our reserve balances with correspondent banks as working balances, and we believe that we receive good service in exchange for them. Under H. R. 14072 balances held with correspondents, however, could not be working balances, due to the "pass through" provisions of the bill. We believe that H. R. 14072 would force us to hold idle balances over and beyond our need for working balances and that an adverse effect would thereby be exerted on our earnings. The long-term prospect under H. R. 14072, therefore, is a dampening of the earnings growth of Bank of Lexington.

Although its growth in deposits and assets has been well above average, the Bank of Lexington has been, and continues to be, below average in its earnings performance. Penetration of the Lexington banking market has been an expensive process, involving aggressive branching for a bank of our size, Saturday banking hours, expansion into a new home office, heavy advertising expenditures, and very competitive pricing of deposit services and loans. Moreover, the Lexington banking market is dominated by one bank which holds about 50 per cent of the total deposits in the market. That bank resulted from a merger in 1961 that was subsequently found by the Supreme Court to be in violation of the antitrust laws but which was immunized and left standing by action of this Congress in 1966. Two years ago the Bank of Lexington sought to merge with another bank in Lexington in an effort to redress the competitive imbalance in the structure of the Lexington banking market. That proposed merger, though approved by the Comptroller of the Currency, was blocked by the Justice Department, and lack of resources to sustain a long, drawn-out battle in the courts forced the two banks to abandon the merger. The local parties involved will never understand how creating a bank with 15 per cent of the deposits in a six-bank community might pose a threat to competition when the largest bank in town has 50 per cent of the market. My comments about the frustrated merger may not seem relevant to H. R. 14072, but they may help explain why some persons in Lexington are inclined to question the wisdom of what comes out of Washington.

As a result of its below-average earnings, its rapid growth, and its failure to accomplish merger with another bank, the Bank of Lexington today faces a serious need to sell additional stock to improve its capital position. We believe that H. R. 14072 adversely affects our prospects for the sale of additional stock. We will need to inform prospective purchasers that Bank of Lexington may soon come under the required reserve ratios of the Federal Reserve. It will be difficult to explain the significance of the exemption levels, and I think that we would have to say that over the longer term we regard the effect on the bank's earnings to be adverse, or at least potentially adverse.

Moreover, the full effects of H. R. 14072 cannot be evaluated at this time. The requirement that the Federal Reserve establish a plan and schedule for pricing its services by July 1, 1979, means that there is still one shoe to be dropped. Indeed we think that the provisions of H. R. 14072 calling for various studies to be made by the Federal Reserve place a whole row of shoes teetering on the brink.

The Bank of Lexington, and we think many banks throughout the nation, would welcome some respite from Washington actions that increase the burden of regulation, increase costs, and do little or nothing to improve banking services to the public in general. We fail to see how H. R. 14072 will increase the effectiveness of Federal Reserve monetary policy. First of all, it is unrealistic to think that monetary policy can do much to stabilize our economy in the face of continuing budget deficits that fuel inflation. Second, the withdrawal of a limited number of banks from the Federal Reserve System has not reduced the effectiveness of monetary policy. The Bank of Lexington has never been a member of the Fed, but it certainly feels the effects of

Federal Reserve actions tightening or easing growth in the money supply. Third, the so-called "membership problem of the Federal Reserve could have been remedied some time ago if the Federal Reserve had embarked upon some plan of reducing required reserve ratios to facilitate growth in the money supply over a period of years rather than buying up billions of dollars of U. S. Government securities to support such growth. In sum, H. R. 14072 has every appearance of being another unnecessary piece of legislation coming out of Washington, hastily considered to meet a "crisis" that does not exist, and containing provisions, especially on Federal Reserve pricing of services, which cannot be evaluated with respect to their longer term effects on bank earnings and the cost of services to the public.

Mr. Chairman, we appreciate the opportunity to express our concerns about H. R. 14072 and to urge that further action on it be deferred until related developments, especially Federal Reserve pricing of services, are more clearly in view.

The CHAIRMAN. Thank you very much, Dr. Haywood.

I am going to confine my questioning to two matters which were brought up which I haven't quite grasped.

Obviously, most members of the panel and myself are in basic disagreement about the bill, and there is no point in our wasting each other's time by arguing it, though I will say I appreciate very much your coming here, your giving me your views. They were carefully listened to.

The supplementary papers you have filed will be carefully studied and at least in terms of a day in court, your trip here is certainly not in vain.

Now, the two matters I have a little problem with: One, Dr. O'Leary, and this was just referred to also by Dr. Haywood, you know from past conversations with me that I share your view that on many occasions the Fed, by excessive money creation, has been part of the problem rather than part of the solution to inflation.

In your testimony you said that you feared that the reduction in reserves, desirable though that might be on the other grounds, would be likely, at a time in the days ahead when monetary prudence is required, and I agree with you, to cause the Fed to be an engine of inflation.

I want a little more elucidation from you on that.

In the first place, the reduction of reserves occurs over what is essentially a 3-year period. That is to say, if this bill passes, which I hope it will, though it may not, there would be a 3-year period starting from last July in which this phase-in would occur. Therefore, the numbers you used, I think, assumed a 1-year period, so I believe one would have to divide that by three.

But that doesn't wholly meet your points. Have I misstated that?

Dr. O'LEARY. No. I was not entirely sure about how long the phase-in would occur.

The CHAIRMAN. The phasing would be 3 years from last July so that some of your point is diluted but not all of it.

Dr. O'LEARY. The numbers are so large that I was just doing a little more arithmetic, and let's say you didn't have a phase-in, but you took the entire——

The CHAIRMAN. I wouldn't have it like that.

Dr. O'LEARY. As I understand, it is a $14 billion figure. I wasn't sure what it was, myself, but something like a $14 billion to $15 billion reduction in required reserves, however, it is phased in, would occur.

Now, at a 7-percent reserve requirement, there is a multiple of 14 times in terms of the expansion——

The CHAIRMAN. This is high-powered money.

Dr. O'LEARY. So that would be a $196 billion potential increase in the money supply, and the money supply today is $357 billion, so you have a better than 50-percent potential expansion in money built into this.

Now, if you took a third of it, even, let's say in May, if that were the timing of it, you would be taking a third of that, and you would be adding to the money supply something like $67 billion, and that would be maybe a 10- or 15-percent increase in money supply.

I am sure that what the Fed's answer to this is, is that they would offset that through their open market operations. But let's assume that

May were a period in which the economy was still going quite strongly and you still had a good growth in the economy and had an 8-percent inflation rate, how comfortable would we feel, and how would the international money markets feel, releasing that sort of a potential for expansion against the background of the fact that in order to mop the money up, the Fed would have to be selling a substantial chunk of securities in an economy.

The CHAIRMAN. The answer is uncomfortable, thus the flexibility of our phase-in period, because we had that in mind.

But let me get to the next point. For me to say to you that we are assured by the Federal Reserve that there is not the slightest inflationary danger here, because of their mopup by open market possibilities, I realize, doesn't entirely reduce the swelling that you are speaking about because of past experience, so leave that aside, but isn't it a fact that the very reduction of reserves at the proper time would put the banks in possession of the do-re-mi necessary to permit an offsetting open market policy articulated in the sale of Treasury instruments by the Fed?

Dr. O'LEARY. Yes, but I think, Mr. Chairman, that the crucial thing here is that to the extent, let us say, interest rates continue to be under upward pressure, there is quite a bit of difference, let us say, between simply raising reserve requirements as one tool and the process of day after day selling government securities in the market. And I think out of this you would get a marked rise in interest rates, assuming that the markets were under an upward pressure.

Now, how would you like a situation in which, let us say, by May of next year, the Treasury bill rate had risen to something like 9 percent—it is currently around 8 percent—but let's say by the spring of next year, if we continue to have a 3½- to 4-percent growth in the economy, you would have a somewhat higher interest rate, in my view, if the inflation rate is as high as everyone anticipates, 7 to 8 percent, and the problem I would see is that out of this, the Federal Reserve would create quite a stir because it would be doing something that would be very visible every day, putting interest rates up at a time when I don't think, from a political standpoint, you would like to have them operating that way.

The danger would be they wouldn't, that they would simply swallow those additional reserves, and you might wind up at the end of 1979 with a 12- or 15-inflation rate out of this whole operation instead of 8 percent.

Furthermore, if you are going to phase this in over a 3-year period, why all the urgency of doing it right now?

The CHAIRMAN. Let me say three things: One, I am grateful for your answer. Two, you made an impression on me. It may well be that we haven't, in the particular language before us, sufficiently safeguarded the onrush which you envisage could happen.

Third, on your point if you have to phase it, why all that rush, I would say simply because you do have to phase it is one reason for getting started, because the sooner you get started, the longer time you have to phase. However, we do not intend to rush like gathering swine on this, and we shall certainly consider the points that you and Dr. Haywood made, because I think it is very important.

Now, another distinguished witness, and then that will conclude my questioning. Mr. McNair, of a big bank, almost $3 billion in deposits, the famous Wachovia, you dilated at some length about the threat to our dual banking system.

Well, next to the Nicene Creed, I am all for the dual banking system, too, but I really fail to see how this bill in which we were at pains to say that the tiniest nonmember State bank in the country could have the same access to the discount window as the powers and principalities of the Bank of America and Citibank and the Rockefellers, and so on, a bill which allows the tiniest bank to buy or not to buy the services offered by the Fed at the same price as anybody else, and which does not mandate membership in the Fed as many empire builders in days gone by would have liked, I really fail to see how we are doing anything mean or unpleasant to the excellent and admiral dual banking system.

Mr. McNair. May I respond?

The Chairman. I hope you will.

Mr. McNair. We feel like, in looking at the bill, that there are a large number of banks, as you know the number, that will be required under the terms of the bill to maintain reserves at the Fed.

The Chairman. It is about 240, including quite a few foreign banks who have just been admitted to the race in this country.

Mr. McNair. Once those reserves are required to be maintained at the Fed, we believe it would be prudent on the part of many of those banks to go the full way and take out membership in the Fed.

We also think that those banks are going to have a problem getting from the Fed the same services that they are today getting from the larger banks in a correspondent relationship.

The Chairman. On that, could I interrupt you there? Unless there is something that escapes me, I don't see the slightest reason why one of those 240 banks, who, under this bill, admittedly is mandated to keep reserves, would in any way be deprived of an option to buy its services from a correspondent bank by compensating balance or any other way, or from the Fed.

Mr. McNair. I think the point is, Mr. Chairman, that these banks are probably not going to maintain the reserves in both places and, as a reasonably large bank, we are not going to feel inclined to service our correspondents unless they do maintain correspondent balances with us.

The Chairman. This is very much on my mind, and I come from generations of correspondent bankers, to disclose where my interest lies. This bill says that the bank may maintain its reserves in relationship with the correspondent bank. The correspondent bank, of course, must deposit that with the Fed, but in terms of daily doing of business, buying of services, we don't change things.

Mr. McNair. If we take $5 million correspondent balance from one of our good correspondents and then have to pass that through on a one-for-one basis, that doesn't leave us a whole lot.

The Chairman. Well, it does leave you in the position of one who renders services in a free market, and you do pretty well with correspondent banking.

Mr. McNair. We have up until this time.

The Chairman. You must be doing something right because they buy a lot of your services.

Mr. McNair. Yes, sir, we hope we have, and we don't want to see you change it.

The Chairman. Well, I am most grateful to you for pursuing this point with me, and I understand your position.

Mr. McNair. Thank you, sir.

The Chairman. Mr. Rousselot?

Mr. Rousselot. Mr. McNair, can you pursue that a little further? How would this bill change that?

Mr. McNair. The reserves that could be maintained in a member bank by a correspondent would then——

Mr. Rousselot. I want you to define it for my chairman so he understands it thoroughly.

Mr. McNair. All right. The reserves by a nonmember bank maintained in a member bank in order to pay for correspondent services would have to be passed through, as I understand it, on a dollar-for-dollar basis to the Fed; therefore, leaving a net zero balance in the correspondent bank.

Mr. Rousselot. And that eliminates your ability to charge for that——

Mr. McNair. No, sir, it eliminates our ability to earn.

Mr. Rousselot. I mean that. I should say to earn. In other words, it decreases the ability of a correspondent bank to earn on that relationship?

Mr. McNair. That is correct. And, as a result, it would decrease the ability for the smaller bank to expect from the larger bank the services that have been furnished them up until this time.

Mr. Rousselot In your opinion, could they get it from the Federal Reserve Board if they became members?

Mr. McNair. Some of the services they could get; others, obviously, or in my opinion, they could not get.

Mr. Rousselot. So both the smaller bank and the correspondent bank would be the losers?

Mr. McNair. In my opinion, yes, sir.

Mr. Rousselot. Does anybody disagree with that here?

The Chairman. Yes; I do.

Mr. Rousselot. But these people are in that business, and I am trying to get an explanation——

The Chairman. I used to be in the business, and isn't it a fact, Mr. McNair, that under our bill, you know, 5,000 member banks would be released from their present obligation to hold reserves at the Fed, and don't you think Wachovia could pick up a few of those as correspondents and manage to survive pretty good?

Mr. McNair. Mr. Chairman, I don't think it is a question of survival. I certainly hope——

The Chairman. With the Fed pricing, it is serious.

Mr. McNair. Of course we don't know what the Fed pricing is going to be, but assuming it is reasonable, I don't think survival of a pretty good size national bank is at issue. I don't think that is the question.

The Chairman. Thank you for letting me intrude.

Mr. Rousselot. I don't mind your intrusion, because you started the line of questioning, and I think it is a very proper one. The claim here is that the smaller banks will lose out on this on the basis of the pass-through requirement, and I just wanted to pursue that. That is all.

The CHAIRMAN. The smaller member banks would be released from their present reserve requirement.

Mr. ROUSSELOT. Now, Mr. McConnell, you mentioned, and we have to go vote here in a minute, in your opening statement, the opening part of your statement, and I wondered what other people here—by the way, how many of you, if you were in our positions, would vote for this bill?

Another stampede.

Well, that is interesting——

The CHAIRMAN. I will mark them down as doubtful.

Mr. ROUSSELOT. Middle of the road.

Now, when you said the bill would impose extreme and unwarranted burdens upon the citizens of Delaware, would those of you who come from other States, do you think that is an unreasonable statement?

Could anybody explain in a little more detail how it affects citizens?

Mr. MCCONNELL. I made the statement, and I will be glad to try to explain it.

Mr. ROUSSELOT. All right.

Mr. MCCONNELL. It is a small State, and our best estimate is that more than $100 million would be removed from the Delaware economy in order to meet the reserve requirements contemplated by the bill.

Mr. ROUSSELOT. Roughly $100 million?

Mr. MCCONNELL. It is in excess of it. I was conservative in the figure.

Mr. ROUSSELOT. You tried to be conservative, and you feel that would reduce, then, the ability of those banks that would be so affected from servicing the citizens of Delaware or their general customers?

Mr. MCCONNELL. It would seem axiomatic if you take the money out of the Delaware economy, speaking for our State, and our State alone, because I recognize the money goes somewhere and can come back into the level of the lake, but it would certainly have that effect as we view it.

Mr. ROUSSELOT. Mr. Orr, you mentioned in your statement, and I want to be sure I quote you correctly, that you had a concern about the pricing of services, and it was not a sure thing as to what it would be.

You are aware that Mr. Stanton amended the bill to define more clearly what he thought the Federal Reserve System should do in the way of schedule fees.

Are you aware of that?

Mr. ORR. Have we seen those fees yet? I haven't.

Mr. ROUSSELOT [presiding]. You are not aware of his amendment?

Mr. ORR. No.

Mr. ROUSSELOT. Well, the bill was amended to that degree, and I must say Mr. Stanton, himself, didn't say it was perfect, but he felt at least there should be a requirement.

It says:

> The Federal Reserve Bank services to banks which shall be covered by the schedule fees under subsection (a) are—

And then he lists eight.

one, currency and coin services; two, check clearing and collection services; three, wire transfer services.

I won't go through all of them, but there are eight listed items.

If you feel that that would partially eliminate the complaint—and I realize this bill changed from the time that it was originally introduced and the time it came out of committee, and I didn't know whether you were aware of that.

Mr. ORR. No; I was not aware. Without study, I couldn't give you a firm answer on it. I can say that our reserves at this point are kept with the correspondent, and those reserves are sufficient to buy the services that our bank needs on a day-to-day basis. And, as I said in my testimony, we have four correspondents competing for those balances, those reserves, and being a small bank those reserves do pay for the services that we need.

Dr. HAYWOOD. Mr. Rousselot, may I comment on that?

Mr. ROUSSELOT. Certainly.

Dr. HAYWOOD. I believe Congressman Stanton's amendment does not set forth a schedule of fees; it sets forth the factors to be taken into account.

Mr. ROUSSELOT. That is right.

Dr. HAYWOOD. And we are all still waiting to see how the Federal Reserve calculates its costs, and they have until next July to come up with a schedule. I think that is what was meant here. We would really have to see the schedule of fees as such to know how it would impact.

Mr. ROUSSELOT. And to know whether they are competitive?

Dr. HAYWOOD. Yes.

Mr. ROUSSELOT. Congressman Stanton, himself, admits that wasn't perfect. He was trying to put something in the legislation to require that something bo done.

Mr. HOLDING. Congressman Rousselot, I would just like to make one point that I think is a very significant point. They refer to and I have heard the chairman, I believe, correctly when he said that the Fed would offer the services to members and nonmembers alike at the same price. Unfortunately, in all too many cases that is an impossibility, simply because the banks in question are not located at points or cities where there is a Federal Reserve office.

Now, admittedly, Federal Reserve membership, I am certain, is a burden to a billion-dollar bank located in the city of Philadelphia, but I can assure you, sir, that Fed membership in a bank located in towns of from 700 people to 50,000 located 90 percent outside of a Federal Reserve city, they are confronted with a much greater problem in the Federal Reserve. Unless they want to open a branch office in every town and hamlet in the United States, they cannot render the same service.

Mr. ROUSSELOT. I appreciate that comment.

I, too, have to go. This is the first time I have been chairman of this committee, because I am all that is left.

Thank you for being here and being present. We do appreciate it, all the members of the committee.

I have a couple suggestions. If you have amendments to this bill that you think are important, my understanding is that it could well be attached to something else, going through at the last minute, so don't assume just because the Senate hasn't completed action that nothing will happen. Funny things happen here at the end.

I would suggest each of you contact your own Congressman and try to explain the best you can what the defects are so that by the time it reaches the floor, we can have an intelligent discussion on the issues that you have presented, because several of the panels today represent different points of view than we had before.

Thank you all. We do appreciate your coming, but don't assume because you have appeared—you can see how many were here—it would not hurt to see your local Congressman when he is home this weekend or within the next week and explain what you think the adverse effects are on the consumer, employment—all the things that you think do not inure to the benefits of the general public. You better explain that.

Our Chairman, Mr. Reuss, expresses his thanks for your attendance, and this adjourns the hearing.

[Whereupon, at 2:52 p.m., the committee adjourned, to reconvene subject to the call of the Chair.]

[The following additional material was received by the committee for inclusion in the record:]

Statement of Edward J. Kane, Everett Reese Professor of Banking and Monetary Economics, The Ohio State University, on H.R. 14072

To avoid unpleasant surprises, policymakers must judge proposals for financial reform by their *unintended* effects, not just by their intended ones. Good intentions not only fail to guarantee good policies, they seem in practice to blind decisionmakers to harmful unintended consequences of structural reforms.

H.R. 14072 is intended to solve the Federal Reserve's membership problem by restructuring Fed reserve requirements and imposing them on a broader set of banking instiutions. These changes seek in particular to make it harder for large banks to escape the web of Fed regulatory dominion.

Unfortunately, the bill's unintended effects threaten to disrupt traditional patterns of conducting banking business and to make the financial sysem more vulnerable to crisis. To explain how and why these unintended effects would develop, it is useful to conceive of reserve requirements as a tax and to analyze the effects that the new reserve-requirement schedule would have on bank and customer incentives.

Reserve Requirements as a Selective Tax

Although Federal Reserve literature scrupulously avoids the term, Fed reserve requirements are at bottom nothing more than a *tax* on deposits. As with any other tax, the level and structure of the reserve-requirement tax rates closely affect government revenues (here the Fed's budget), taxpayer incentives, and the after-tax distribution of income. Even though effects on Federal Reserve revenues are relatively unimportant, Fed revenues could fall because reserve pyramiding is allowed under the proposed schedule of reserve requirements. This schedule would also have unfortunate incentive and distribution effects.

Considered very narrowly, reserve requirements constitute an excise tax on selected commercial-bank liabilities. This selectivity lies at the heart of the incentive and distributional problems the requirements raise. The tax base against which Fed reserve requirements are currently levied consists of the deposit liabilities of member commercial banks. Member banks' nondeposit liabilities (principally repurchase agreements and federal-funds transactions) are exempt from the reserve tax, as are deposits at such closely competing institutions as nonmember commercial banks, mutual savings banks, savings-and-loan associations, credit unions, and money-market mutual funds.

Currently, Fed requirements tax demand deposits more heavily than time and savings accounts and tax each type of deposit more heavily at large member banks than at small ones. Finally, requirements are higher on short-term certificate accounts than one longer-term CDs.

EFFECT OF RESERVE-REQUIREMENTS SELECTIVITY ON FINANCIAL INCENTIVES

A tax that simultaneously treats member banks and their competitors so differently and that establishes so many differential tax rates for member banks sets up incentives for member banks and their customers to reallocate deposit funds into lightly taxed types of accounts and especially into exempt instruments. Member banks can lighten their tax burdens either by becoming nonmembers or by making exempt instruments and low-requirement deposits more closely substitutable for higher-requirement types of accounts. Customer pressure on banks to make such changes is heightened by competition from untaxed institutions, who are encouraged to invade banking markets by improving the substitutability of their liabilities for reservable deposits at member banks.

This regulation-induced innovation and customer response correspond to ordinary tax-avoidance activity. These actions lower the burden that the statutory schedule of reserve requirements would otherwise place on banks and their customers. In the process, they generate unintended changes in the distribution of customer funds across categories of accounts at member banks and between member banks an competing institutions.

PRINCIPAL UNINTENDED EFFECT OF H.R. 14072

Using this perspective, the reserve-requirement schedule featured in H.R. 14072 can be seen to discriminate—especially at large commercial banks—against banks' most traditional ways of raising funds. First, it taxes deposit liabilities but leaves deposit-like nondeposit sources of funds (such as repurchase agreements) absolutely untaxed. This discriminatory tax on deposits is reinforced by differential regulatory burdens already imposed on deposits at federally insured banks by deposit-rate ceilings and FDIC insurance fees. Since nondeposit liabilities tend to be negotiated individually, they are seldom available in small denominations. Hence, the reserve-requirement tax falls more heavily on household than on business customers, with the burden tending to fall with a household's income and wealth. During the last two decades, nontraditional liabilities have become an increasingly important source of funds at large commercial banks, increasing these banks' exposure to potential crisis. H.R. 14072 would tend to encourage smaller banks as well to emphasize innovative liability arrangements.

Second, H.R. 14072 raises requirements on ordinary passbook or statement savings accounts to the level imposed on checking accounts, presumably because electronic payments innovations and emerging provisions for automatically transferring funds from savings accounts to cover checking-account deficits are making passbook savings accounts almost as accessible as demand deposits. This increased accessibility has developed in response to deposit-rate ceilings, both as a way of paying explicit interest on checkable funds without strictly violating the prohibition against interest on demand deposits and as a way of paying implicit interest (in enhanced transactions services) on savings accounts. While these developments make regulatory distinctions between the two types of accounts harder to formulate, banks and their customers will still find it economical to discriminate between transactions and savings balances. A supply of relatively idle passbook-type funds exists. Because households value the *option* of being able to draw quickly on their savings in emergencies, such accounts are less costly to administer and generate less pressures on bank liquidity than do transactions accounts. Taxing transactions and precautionary savings balances similarly may be convenient for regulators, but it figures to hurt the banks. Together with the high requirements imposed on short-term certificate accounts, the unintended result is to give financial institutions not subject to reserve requirements an increased advantage in competing for household savings funds.

ANOTHER UNINTENDED EFFECT

H.R. 14072 includes a curious provision to allow a bank's deposit balances at other commercial banks to count as required reserves whenever the depository bank maintains at least an equal amount of balances at the Fed. Presumably, this relaxation of the Fed's compositional requirement is meant to cushion the impact of universal reserves on the market for correspondent services.

However, this change opens the door to substantial reserve pyramiding. At the depository bank, the bill excludes bankers' balances both from FDIC assessments and from reservable liabilities, and it contains no language to preclude depository banks from using counterpart balances at the Fed simultaneously to meet their own requirements. Because interbank balances yield an implicit rate of return in the form of correspondent services whereas cash and (at least under the projected schedule of Fed service charges) balances at the Fed do not, across the system as a whole in discharging reserve requirements, maximal use should be made of interbank balances. Hence, Fed requirements would be much less burdensome than statutory ratios would suggest. This is particularly true for banks that currently belong to the Federal Reserve System, whose holdings of balances at other banks do not currently count at all toward Fed reserve requirements.

SUMMARY

Reserve requirements are a tax. As such, differences in the rates applicable to different institutions and to different types of liabilities must be justified carefully in terms of both efficiency and equity. Differences in the level of reserve requirements on different types of depository-institution liabilities (including the absence of reserve requirements on innovative liabilities), tend to favor the growth of less heavily taxed types of liabilities over more heavily taxed ones. Moreover, the spread of electronic payment services is lessening traditional distinctions between depository firms and other types of financial institutions. Untaxed producers of deposit substitutes (such as money-market mutual funds and broker cash-management accounts) will tend to expand at the expense of traditional depositories.

H.R. 14072 establishes incentives to transform the liability side of bank and competitor balance sheets in ways that would make individual banks and the financial system more vulnerable to financial crisis.

GATEWAY BANK,
Greensboro, N.C. September 22, 1978.

Hon. STEPHEN NEAL,
House Banking Committee,
U.S. House of Representatives, Washington, D.C.

DEAR REPRESENTATIVE NEAL: Please be advised that I am opposed to the passing of Bill H.R. 14072 in which all banks over $100 million in deposit will be required to keep reserves with the Federal Reserve at levels set by the Federal Reserve.

It appears to me, based on my understanding, that this bill would be much more equitable to all concerned if certain changes were made—many of these changes having been presented by the American Bankers Association.

Sincerely,

RALPH H. BOWDEN,
President.

AMERICAN BANK AND TRUST CO.,
Monroe, N.C., September 21, 1978.

Hon. STEPHEN L. NEAL,
Cannon Building,
Washington, D.C.

DEAR CONGRESSMAN NEAL: I want you to know that I oppose very vigorously the provisions of H.R. 10472.

First of all, I think that action on this should be deferred until all possible effects can be identified. Secondly, I think this bill is far-reaching and potentially harmful to the dual banking system, correspondent banking and the principle that Fed membership should be voluntary.

I will appreciate your careful consideration of my viewpoints.

Sincerely yours,

E. D. GASKINS,
Chairman of the Board, Chief Executive Officer.

WESTERN CAROLINA BANK & TRUST CO.,
Asheville, N.C., September 21, 1978.

Hon. STEPHEN L. NEAL,
House of Representatives,
Cannon Office Building, Washington, D.C.

DEAR CONGRESSMAN NEAL: I am writing and strongly urging you to delay voting on House Bill H.R. 14072 concerning common reserves for banks in the Federal Reserve Bank. In my opinion, this bill should not be voted upon until it gets the proper hearing in committee and, also, proper hearing from the banking community and others as to the effect it may have on the banking community. I, as well as many other bankers, feel that input from the banking community can strengthen any regulation and, therefore, make these regulations more effective.

Cordially yours,

SAMUEL L. BLYTHE,
President.

THE HERITAGE BANK,
Lucama, N.C., September 21, 1978.

Re: H.R. 14072.
Congressman STEPHEN NEAL,
House of Representatives,
Washington, D.C.

DEAR CONGRESSMAN NEAL: Although the above bill does effect our bank, at the present time because of the $100 million requirement, I feel very strongly about this bill. It is true that it does not effect us at this point because of the deposit requirement but once it is approved it is surely to have amendments that will eventually effect the small bank. This bill is going to greatly effect the corresponding banking relationships of all banks and without a good correspondent relationship we would be hurt very badly.

I also feel that this bill will eventually do away with the dual banking system in our country, which to me is vital to the economy and to the soundness of bank.

I hope that you will give very serious consideration to this bill and will oppose it in Committee and on the House floor.

Very truly yours,

TOM LUCAS,
President.

BANK OF GRANITE,
Granite Falls, N.C., September 20, 1978.

Hon. STEPHEN NEAL,
House of Representatives, Cannon House Office Building,
Washington, D.C.

DEAR CONGRESSMAN NEAL: I am very much concerned about the manner in which the House Banking Committee approved H.R. 14072 and strongly suggest that more thought and study be given to the issues raised by this proposed bill. It threatens the very foundation of our dual banking system and is particularly onerous to state non-member banks such as the Bank of Granite.

I very much hope that you will do everything you can to work against passage of this legislation.

Thank you and best personal regards.

Sincerely yours,

JOHN A. FORLINES, Jr.

COMMERCIAL & SAVINGS BANK,
Boonville, N.C., September 21, 1978.

Congressman STEPHEN NEAL,
House of Representatives,
Washington, D.C.

DEAR CONGRESSMAN NEAL: I would like to express to you my total opposition of Bill (H.R. 14072) requiring all banks with over $100 million in deposits to keep their required reserves with the Federal Reserve at levels set by the Fed. It seems to me that this would result in an end to the principle that Federal Reserve Membership should be voluntary. I feel that requiring any bank to become a member of the Federal Reserve would be a damaging blow to our banking system as we know it today and one that I feel everyone could be proud of. The passage of this bill could cause many large banks that are not Federal Reserve members to switch from a state charter to a national charter.

Being the Chief Executive Officer of a small state bank, I feel that this could be a damaging blow to the dual banking system. In many or all states it would diminish the financial strength of our state banking departments. I feel that this would put a great financial strain on the small banks that would continue to retain their state charters and eventually cause them to have to switch to a national charter due to the higher financial cost of obtaining a state banking department for these banks.

It seems that our dual system in the past has worked so well and has been beneficial to the banking industry that we should not do anything to destroy this system. Again, I would like to express my opposition to this bill and ask that you consider opposing it in any way that you can.

Sincerely,

JOHN W. SHORE, Jr.,
President.

THE FIRST NATIONAL BANK OF RANDOLPH COUNTY,
Asheboro, N.C., September 21, 1978.

Re: H.R. 14072.

Representative STEPHEN NEAL,
House Banking Committee
Raleigh, N.C.

DEAR MR. NEAL: It is my understanding that on September 22 there will be a hearing before the House Committee on Banking regarding H.R. 14072. It is in this regard that I write to you.

I represent a bank of approximately $60 Million in assets and am a member of the Federal Reserve System. I am greatly concerned with the apparent need for quick action on this bill when it has so many implications that in my judgment have not been examined to the fullest extent. The dual banking system has worked for many years and I think to make changes in the entire setup without carefully examining all of the consequences could be disastrous.

I am not at all sure what kind of cost the Fed proposes to charge for services, or what the end result would be in the change in Fed membership and the cost to my bank or to much larger institutions. I live with this business day to day and I am unsure of the course of action in it and it concerns me greatly that the House of Representatives could possibly make such a sweeping decision without regard to the feelings of those who are affected by it on a day to day basis. I would hope that the Committee would vote against H.R. 14072 or, at least, extend the time for more extensive hearings and understanding of the total problem before making such drastic action.

Thank you for looking into the matter.

Cordially,

JAMES M. CULBERSON, Jr.,
President.

PEOPLES BANK & TRUST CO.,
Rocky Mount, N.C., September 21, 1978.

Hon. STEPHEN NEAL,
House of Representatives,
Washington, D.C.

DEAR CONGRESSMAN NEAL: I am writing you in regards to the bill before the House Committee on banking finance and urban affairs, Bill No. H.R. 14072. This bill, as you know, would require all banks with over $100,000,000 in deposits to keep their required reserves with the Federal Reserve at levels set by the Federal Reserve Board

As a State non-member bank, we would be directly affected by this bill, and while I have very strong feelings in opposition to the bill for a number of reasons, one being that in my opinion it has been hastily conceived and not given proper consideration, I will confine my comments on these two areas. First, I believe very strongly in the dual banking system and, while I have no anti-Federal Reserve feelings, I believe that banks such as ours should have the option of continuing to choose between a state and national charter and the choice of belonging to the Federal Reserve System or not belonging to the System. This bill, it seems to me, removes this choice in that it requires banks such as ours to become a part of the Federal Reserve System. In my opinion, the dual banking system has served our nation and the public sector which we serve very well. Secondly, you are very much aware of the fact that North Carolina is a capital deficit state and our bank finds it necessary to conserve our resources to the maximum extent so that we can better serve our customers' borrowing needs. Our particular bank is still very strongly influenced by agriculture and last year, as an example, found us in the position of having to carry over numerous farm loans into this year with the hope that we would have a better crop that would allow our customers to meet their loan obligations. In addition to the necessity of carrying over many of our agricultural loans, we found that the sharp fall in deposits because of the poor crop last year increased our loan demand and the pressure on our liquidity position. Fortunately, we have this year been able to take care of our customers' requirements for new credit and the crop prospects for this year are much improved. However, it has been a year that has required our managing extremely closely our liquidity position and we frankly have had no excess reserves available to us. I think this bill would be detrimental to a bank such as ours and add additional unnecessary pressures on the availability of credit to our farm customers as well as our other borrowers.

Summing up—I do oppose this bill for a number of reasons, most particularly its effect in removing our choice as to membership in the Federal Reserve and the adverse effect that this bill could have on our meeting our customers' borrowing requirements.

I appreciate very much your interest in this matter and the fine manner in which you are representing our State in Washington.

Sincerely yours,

W. H. Stanley,
Chairman and president.

Merchants National Bank & Trust Co.,
Indianapolis, Ind., September 13, 1978.

Hon. David W. Evans,
House of Representatives, Cannon House Office Building,
Washington, D.C.

In a spirit of "Solve the crises of inflation, the economy, the dollar, the conduct of monetary policy, and the Fed membership problem" do not address the goal of universal reserves for all depository institutions. The bills do call for a reduction in reserves for present Fed members, but with the very serious caveat of shifting the philosophy of the Federal Reserve System to one of mandating reserves for all large banks as opposed to the present system of voluntary membership.

More specifically, legislative measures currently before the House Banking Committee would require all banks over a certain deposit size ($100 million in one, $50 million in another) to maintain reserves on deposits in excess of that amount at levels set by the Fed, whether those banks are Fed members or not.

The implications of the shift in philosophy to mandating a certain level of captive Fed reserves are very serious. There is no way anyone can make intelligent judgements on the impact of this dramatic change in the few weeks remaining before the 95th Congress adjourns. Failure to have thought through these implications prior to passage of legislation causing such sweeping change in our banking system would be a dereliction of leadership.

We urge the two banking committees to defer action on these bills until the next Congress so more can be understood and possible alternative approaches can be suggested. The interim alternative being offered by the ABA is to proceed with the agreed-upon reduction in reserves of member banks and a requirement of reporting relevant deposit data from all depository institutions to the Fed.

The stakes in the outcome of the present debate are potentially very high relative to the future structure of the banking system and the maintenance of relative independence of the Fed from constant political pressure. The stakes are too high for hasty action to be taken where there is no need for such action. Important unknowns are being ignored. Deliberate consideration in the next Congress is clearly in the interest of all banks.

Your consideration of our concerns will be greatly appreciated.

Yours very truly,

Otto N. Frenzel III,
Chairman.
D. W. Tanselle,
President.

COMMONWEALTH OF PENNSYLVANIA,
DEPARTMENT OF BANKING,
Harrisburg, Pa., September 21, 1978.

Hon. WILLIAM S. MOORHEAD,
House of Representatives, Rayburn House Office Building,
Washington, D.C.

DEAR CONGRESSMAN MOORHEAD: It is my understanding that the testimony on the uniform reserve proposal (H.R. 14072) which will be heard on Friday, September 22, 1978, will be limited to bankers. I asked to testify at those hearings because of a number of concerns I have about the proposal.

My chief concern arises from the possible and unintended effects which the current proposals may have on the dual banking system. Although I would have developed each point in greater detail in testimony, let me just outline the items which still pose many questions for me. I would like to start with the basic assumption which underlies the bill and then proceed to more specific items.

The Federal Reserve System has frequently argued that it needs uniform reserve requirements in order to control effectively the money supply or to hit whatever monetary targets it sets for itself. I have heard many officials of the Federal Reserve state this and assert it vigorously, but I would note for the record that there has been no Federal Reserve study to demonstrate the economic necessity for the uniform reserve proposal they advocate. I find it exceedingly curious that an institution which employs more monetary economists than perhaps any other institution in the world has not produced a single academically respectable study to support such an important theoretical proposition. Many economists—and I am certainly one—would be quite interested to see what justification the Federal Reserve would use for making such an argument. This is not a situation where the case is so obvious that it does not require construction. The question is important, and I believe it deserves formal study. This is especially true when there have been studies done which show that the Federal Reserve does *not* need such authority. I am certain that the Federal Reserve is aware of the studies demonstrating that such controls are not necessary, and I have always been quite surprised that no formal rebuttal has ever come from the Federal Reserve System. In short, I would argue that the extension of uniform reserve requirements is not a control which the Federal Reserve needs for the proper execution of monetary policy.

Even if one were to believe, assert, or concede for purposes of argument that the Federal Reserve System needs uniform reserve requirements, one must wonder why the structure which has been proposed makes good economic sense. For example, what economic rationale underlies the exemption of those institutions having less than $50 million in deposits? Would not the transfer of funds between larger and smaller institutions have a potentially disruptive effect on monetary policy under the current proposal of no reserve requirements at all for smaller institutions and some positive level of reserve requirements for larger institution? The proposed structure undermines the suggestion that uniform reserve requirements are a prerequisite to effective monetary control. Furthermore, there is the troublesome question of nonbank financial intermediaries which have third-party payments powers. Many economists would draw little distinction between demand deposits in a commercial bank and those deposits on which share drafts are drawn in a credit union, for example. Likewise, are the deposits subject to check in a growing number of savings and loan associations not essentially the same as demand deposits in a commercial bank? Should reserves not be required on those deposits as well for monetary control?

The Federal Reserve asserts that information to be obtained from nonmember banks will allow it to conduct monetary policy more effectively. I have no objection to allowing the Federal Reserve to collect whatever information it needs in this regard. However, uniform reserve requirements is not a necessary prerequisite to the collection of such information. There is certainly no inherent connection between gathering information and uniform reserve requirements, and I believe nonmember banks would cooperate with the Federal Reserve in compiling the data the Federal Reserve needs for pursuing its objective in terms of whatever targets it sets for itself.

The current proposal on uniform reserve requirements would clearly remove the opportunity for state regulators to set whatever required reserves they believe necessary for the safety and soundness of state-chartered institutions. This might be justified if the case for overriding economic necessity—on grounds of effective execution of monetary policy—had been established. No such case has been made, however; and one must question seriously the preemption of state regulation in this area. I believe the long-run effect of the current proposal could well be the destruction of the dual banking system. If that is the intended objective, I believe the Federal Reserve or Congress or both should state the objective clearly and ask for some debate on the merits of that proposition. The clear possibility that such a result might flow from the current proposal should create congressional reticence to act before the proposition has been explored thoroughly. I agree with Congressman Reuss that this is probably the most important piece of banking legislation since the 1930s, and I do not think it should be passed before the implications of the legislation have been examined.

Finally, I have some incidental concerns such as the likely effects on the efficiency with which the banking system has worked through a system of correspondent relationships. I am not here suggesting that Congress be careful to protect competitors—quite the opposite. I believe Congress should be aware of the need to preserve the level of competition which presently exists in banking and to heighten that competition wherever it serves the public interest. The current proposal might well so disrupt existing correspondent relationships as to result in a long-run diminution of competition in the banking system. This is another of those possibilities which I think Congress should examine before it takes final action on this measure. As a bare minimum, would it not be a good idea to see the pricing schedule which the Federal Reserve proposes and to have that information become a part of the entire debate?

Examination of the work I have done as an academic economist, a look at any of the actions I have taken since becoming Secretary of Banking, or a discussion with the bankers or other members of financial institutions I regulate will all support my vigorous endorsement of greater competition and increased efficiency in the banking system and in financial markets as a whole. If I thought the current proposal would advance those objectives, I would be a strong supporter of it. Unhappily, I can find little public gain and a considerable potential for public harm in the uniform reserve plan. I am, therefore, forced to conclude that the bill should not become law. Certainly it should not be enacted without considerable study and debate of the various issues which it poses and careful scrutiny of the potential mischief which it might permit.

Sincerely,

William E. Whiteside,
Secretary of Banking.

[Mailgrams]

The Oregon Bank,
Portland, Oreg., September 20, 1978.

Hon. Henry S. Reuss,
Chairman, House Banking, Finance and Urban Affairs Committee, House of Representatives, Washington, D.C.

Our bank, the Oregon Bank, is the largest State nonmember bank in Oregon. We formerly were members of the Federal Reserve System and withdrew from membership in the late 1960's. We withdrew for several reasons, namely because the services we needed could be and were better provided by correspondent banks who were and still are members of the Federal Reserve System.

Our reserve balances with them increased their deposit totals on which they have to maintain reserves with the Federal Reserve.

The dual system of banking has been most effective during its entire tenure and, in my opinion, would be destroyed by the passage of H.R. 14072. The resulting effect of passage of the bill has a direct effect on States' rights which goes beyond the dual system of banking.

The passage of this bill would probably increase Federal Reserve memberships which is one of the purposes of the legislation, but in so doing would substantially weaken structure of many small banks under 50 million dollars in size. These banks now have to maintain reserves as a safety valve to good banking practices. Without reserves some banks could wheel and deal at will, creating a weakness in the banking industry. Reserves were originally mandated as a safety factor to the banking industry.

In the case of larger State nonmember banks, a mass conversion could occur by changing to a national bank charter to be under one regulator. Since the passage of the bill would mandate reserves to be deposited with the Federal Reserve, this action probably would result.

As a member of the State banking board, I would be very much concerned with the withdrawal of large State chartered banks to a national charter. This would require the reduction of a banking board budget which would have a tremendous impact on the regulation of our State chartered banks.

In the State of Oregon, this transfer of reserves would reduce the investable dollars of State non-member banks in amounts of not less than 50 million dollars and possibly higher than a 100 million dollars. This would have a disastrous affect on Oregon's economy. We are a capital poor State. The reducing of dollars available to our economy would eliminate jobs and reduce taxes which is contrary to your intent.

I believe that Federal Reserve membership could be increased by substantial reduction of reserves, and not mandating that the deposits be maintained with the Federal Reserve System. This action I believe, would encourage return of some banks to the Federal Reserve. Further study should be given to the other many facets of H.R. 14072, hearings and opportunities for all banks and other financial institutions to provide input to the reserve questions should be provided before the actual passage of this legislation.

Banks alone do not cause the entire problems of reserves and membership. Other financial agencies, savings and loans, credit unions, et cetera should be included in the proposed change to provide information in establishing monetary policy.

Our current dual system has served well for years without major problems. An extension of time of several months could prove time for additional input. With this provision of additional time, an acceptable alternative to this present proposed legislation could be developed.

I appeal to you and your committee to delay this legislation and allow many of us affected to assist you in arriving at an acceptable compromise to this most complicated issue.

V. E. Solso,
President.

Hawaii Bankers Association,
Honolulu, Hawaii, September 22, 1978.

Re H.R. 14072—Federal Reserve Act Amendments of 1978.

Hon. Henry S. Reuss,
Chairman, Committee on Banking, House of Representatives, Rayburn House Office Building, Washington, D.C.

The House Banking Committee had reported out H.R. 14072 (formerly numbered H.R. 13847) requiring all "large" banks to maintain reserves with the Federal Reserve Bank. Essentially this bill would kidnap all six State-chartered banks, holding 96 percent of all banking assets in Hawaii, into the Federal system. The other two national banks in Hawaii ironically will probably be exempted because of their size. Conceivably there will be no State banking system in Hawaii—all six State-chartered banks will find dual membership (requirements) too restrictive or too costly.

It is not believable that Congress wants big banks only subject to Federal laws and leave State banking regulators with all small banks. Compelling corporate citizens (which opted to incorporate under State laws) involuntarily into a Federal banking system is unjust. Surely there must be constitutional issues affecting State rights and equal protection, among others. If determining monetary policy from reserve data is the intent, surely a better alternative would be to use modern telecommunications system for the same date from covered institutions—mutual savings banks, savings and loan associations, and credit unions included.

Savings and loan associations and credit unions in Hawaii and elsewhere offering transaction accounts (telephone payments and share draft) are not subject to the planned reserve requirements. Because these institutions offer services comparable to bank checking accounts, inclusion of their data is increasingly more important to the money supply statistics.

Hawaii statutes will exempt State-chartered banks from Hawaii reserve requirements if these banks join the Federal Reserve membership. If not, these banks would be required to maintain reserves under both Federal and State laws—unless the latter is changed. Please note that most of the required reserves under Hawaii laws are maintained with correspondent banks and generate earnings—not so under H.R. 14072. Additionally correspondends provide many valuable services not available from the Federal Reserve, because of our geographic isolation and time differences, Hawaii banks cannot fully utilize the limited Federal services.

In summary, the Hawaii Bankers Association is opposed to H.R. 14072 because of (1) its destructive effect on our State banking system, (2) its devaluation of our correspondent relationship, (3) its failure to recognise impact of and include transaction accounts offered by competing financial institutions on our money supply data, (4) its effect on bank operations and the availability of loanable funds in the community, (5) possible constitutional issues related to equal protection, sovereignty of States, etc. and (6) other matters.

Your help and understanding is very much appreciated.

Sincerely,

CLARENCE T. TABA,
Executive Vice President.

SANTA MONICA BANK,
Santa Monica, Calif., September 19, 1978.

Hon. HENRY S. REUSS,
Chairman, House Committee on Banking Finance and Urban Affairs, House of Representatives, Washington, D.C.

I strongly oppose H.R. 14072. This is discriminatory legislation at the expense of the commercial banking industry of this country, and could lead to the eventual destruction of the dual banking system. This very system has been the leader in supporting small business throughout the United States. It is a system that has created the most flexible, innovative, customer-oriented system with the lowest interest rate cost to the consumer to be found any place in the world, furthermore, this legislation will be extremely costly to our bank and will deprive us of the necessary funds to continue the support of the loan requests of small business.

If you sincerely desire to resolve the Federal Reserve System's membership problem, the most promising way to solve the problem would be to reduce Reserve requirements by authorizing the Fed to set Reserve requirements on transaction accounts for all federally chartered and State chartered depository institutions.

AUBREY E. AUSTIN, Jr.,
Chairman of the Board and Chief Executive Officer.

NORTHEASTERN BANK OF PENNSYLVANIA,
Scranton, Pa., September 21, 1978.

Hon. HENRY S. REUSS,
Rayburn House Office Building,
Washington, D.C.

On January 2, 1974, Northeastern Bank of Pennsylvania converted from a national chartered bank to a State charter and withdrew its membership in the Federal Reserve System. The change had a dual purpose; first, to expand the funds available for loans in the bank's business area and second, to improve the earnings on the shareholders investment in the bank. The more realistic reserve requirement of the Commonwealth of Pennsylvania allowed the bank to accomplish its goals.

On December 31, 1973, the bank had outstanding loans of $316,412,126; this amount increased in 6 months to $346,265,265 at June 30, 1974. The increase of $40,000,000 was partially funded through the $16,000,000 Reserve funds released from the bank's account at the Federal Reserve Bank, Philadelphia at the time the bank's membership was withdrawn.

Should Northeastern Bank again be required to maintain non-income-producing funds at the Federal Reserve Bank, both orginal goals would be reversed because approximately $20,000,000 would be withdrawn from the bank's available lendable funds. To this end, we ask that the position of this bank and other State nonmember banks be considered during your hearings on the Federal Reserve Act amendments.

Your support of the "dual banking system" under which Northeastern Bank and other similar banks will remain with a freedom of choice as to which system to be a member and maintain its reserve requirements will be appreciated.

DAVID L. TRESSLER,
President and Chief Executive Officer.

CITIZENS VALLEY BANK,
Albany, Oreg., September 20, 1978.

Hon. HENRY S. REUSS,
Chairman, House Banking, Finance and Urban Affairs Committee, Rayburn Office Building, Washington, D.C.

As one of the banks that would be subject to the provision of H.R. 14072, we have just been notified of the hearing before your committee scheduled for Friday September 22, 1978. Because of the short notice, we will be unable to appear so we are using this letter to express our opposition to the measure.

We know there is a problem that our Federal Reserve System must resolve, but H.R. 14072 is a poor solution to that problem. We respectfully request your consideration of the following: (1) at the end of 1977 national banks held 71 percent of the deposits in the State of Oregon. Further concentration is unnecessary; (2) as the State-chartered banks in Oregon keep their reserves with their correspondent banks. Those funds are available to support the economy of Oregon. The shift of those reserve deposits from correspondent banks to the Fed would hurt that economy; (3) it appears that the procedure used to develop this legislation is poor. It is being pushed too fast and it is critical that more study be given to this issue; (4) the measure is a real threat to the dual banking system, and the dual system has always been a fundamental States rights issue; (5) while cost is not the most important issue here, we must recognize that the change would increase our cost substantially, and the increase would be passed to our customers.

Please give this problem of our Federal Reserve System the consideration it deserves, and help us find a better solution than is provided by H.R. 14072.

HOWARD HIKAM,
President.

FIRST STATE BANK OF OREGON,
Milwaukee, Wis., September 20, 1978.

Hon. HENRY S. REUSS,
House Banking, Finance and Urban Affairs Committee, Rayburn House Office Building, Washington, D.C.

Despite our efforts to import more loanable funds into Oregon we are still capital poor and unable to satisfy our local loan demand. H.R. 14072 as written would reduce our loanable funds by 10 million dollars. This will hurt the people of Oregon and the economy of the State. This proposal has not received enough study of its industry effect or its effect on its economy. Please do everything possible to delay H.R. 14072 in Rules Committee and oppose on the floor.

ROBERT W. FRANZ,
President.

[Telegrams]

CITY BANK,
Honolulu, Hawaii, September 21, 1978.

Hon. HENRY S. REUSS,
Chairman, Committee on Banking, Finance and Urban Affairs, Rayburn House Office Building, Washington, D.C.

As you may know the Banking Committee of the House of Representatives is in the process of considering legislation to solve the Federal Reserve membership problem. There is a bill, H.R. 14072, which would require reserves of all large commercial banks. We believe if the bill is enacted the financial impact on all banks and the economic consequences on the community would be most severe. We also believe the bill would reduce the effectiveness of the dual banking system which has historically accounted for the innovative character of our American banking system. The bill would result in banks maintaining a higher level of sterile reserves maintained out of State. This reduction in lendable funds would mean a loss in income to the bank and decreased dividends to stockholders. Thus the consequences of the bill would affect the economy and growth of the State of Hawaii. We would recommend an impartial survey to be taken on the effects on the banking industry, the demise of the dual banking system and the economic consequences on communities.

Sincerely,

RICHARD T. OKINAKA,
President and Chief Operating Officer.

FIRST NATIONAL BANK OF OREGON,
Portland, Oreg., September 20, 1978.

Hon. HENRY S. REUSS,
House Banking, Finance and Urban Affairs Committee,
Washington, D.C.

H.R. 14072 which is so important to all financial institutions should have their input and more in-depth study before enactment. We urge you to delay passage of this bill.

LELAND H. JOHNSON,
President.

CITIZEN'S BANK OF OREGON,
Eugene, Oreg., September 21, 1978.

Hon. HENRY S. REUSS,
Washington, D.C.

DEAR MISTER CHAIRMAN: We urge you to delay further action on H.R. 14072 until appropriate studies can be conducted that would assess the far reaching implications of this bill. Your efforts are to find a solution to the membership problem of the Federal Reserve System. But other avenues such as lowering reserve requirements for present members would be more productive and would be in keeping with the valued concept of a dual banking system.

The information on hand strongly suggests that on a regional basis H.R. 14072 would have a detrimental impact on the funds available for lending by comercial banks. This in turn would impact our economy and could lead to lower employment levels. Increased costs that will be incurred by us and other banks as a result of this bill will of necessity be passed on to the consumer. H.R. 14072 places the banking system of this country on a road of unknown destination without the proper and thorough study that should be required before changes of this magnitude are undertaken.

CRAIG ROBINSON,
President.

FIRST HAWAIIAN BANK,
Honolulu, Hawaii, September 22, 1978.

Hon. HENRY S. REUSS,
Chairman, Banking, Finance and Urban Affairs Committee, House of Representatives, Rayburn House Office Building, Washington, D.C.

I strongly oppose H.R. 14072 because of the undeniably adverse impact that its passage would have on the Hawaiian economy. Let me justify this position explicitly and succinctly.

1. Hawaii's eight banks serve a key role in financing the Hawaiian economy, particularly in the area of housing which is in very short supply in Hawaii. Over 46 percent of all bank loans in Hawaii are real estate loans.

2. Savings in local financial institutions are not adequate to the financing needs of the Hawaiian economy. This bank borrows extensively from overseas in order to try to supply the capital needed locally as do the other lenders. For example, we currently are servicing $277 million of real estate mortgages that we had originally issued but have sold to mainland investors in order to permit us to make more mortgage loans.

3. The sterilization of approximately $125 million of the assets of the local Hawaiian banks by requiring deposits with the Federal Reserve System would seriously widen the already existing gap between the volume of lendable funds and the demand for those funds from local businesses and individuals. In the case of this bank alone, the amount involved is approximately $45 million in additional reserves that would be required over and above the reserve now required by the State regulating agency.

4. The reserves required by H.R. 14072 would have a more adverse impact on Hawaii than on any other State. Because of our isolated location some 2,500 miles out in the Pacific Ocean, membership in the Federal Reserve System has never been of any value to Hawaiian banks. Of the eight banks in Hawaii, only the two newest and smallest (with only 4 percent of total bank assets) are members of the Federal Reserves System. Consequently this legislation would affect 96 percent of the banking industry in Hawaii far more than that of any other State.

5. Because of Hawaii's great time and spatial distance from any Federal Reserve Bank, and therefore the lack of any benefit from Federal Reserve System membership. No bank in Hawaii was ever a member of the System until recent

years. This bank (First Hawaiian) was not even a member prior to 1959 despite the fact that at that time we operated under a national charter: National banks in the territory of Hawaii were not required to become members of the Federal Reserve System.

For all the above reasons, we are very much opposed to the passage of H.R. 14072.

Should national considerations dictate the passage of the bill, serious consideration should be given to exempting Hawaii banks. As indicated in four and five above, there is adequate precedent for such exemption.

JOHN D. BELLINGER,
President.

WESTERN BANK,
Coos Bay, Oreg., September 21, 1978.

Hon. HENRY REUSS,
Washington, D.C.

DEAR SIR: On behalf of my bank and the entire banking industry I wish to coment and place on record our feelings on proposed legislation H.R. 14072.

Western is the third largest State chartered bank in Oregon. Our service area is primarily in the rural area of the State serving the timber and agricultural industries. On several occasions in the past we have explored the practicability of Federal Reserve membership and each time our Federal Reserve contact has admitted, after careful research and analysis, that it would not be in our bank's best interest to become a Federal Reserve member as they were unable to provide the services provided by our regular correspondent banks due to the location of our bank and its branches.

Although some information on this proposed legislation has been available in various news publications, we only yesterday obtained a copy of the latest updated version of H.R. 14072. Since the ramifications of H.R. 14072 are many and the long range implications are uncertain we cannot determine its exact impact on our bank nor on the economy of the State of Oregon. However, preliminary data does suggest that it would reduce lendable funds in this State by as much as $100 million. In addition the uncertainty of the pricing schedule to be adopted by Federal Reserve and the inability of our bank to even compile adequate data to determine the exact impact of the reserve requirement of H.R. 14072, leave many questions unanswered.

The proposed legislation seems to be entirely missing the generally accepted point of why reserves are required of banks in the first place and instead appears to be trying to convert something that was considered to protect the consumer (depositor) into a entirely different thing. It will cost the consumer more and reduce the taxes paid by financial institutions. This appears to be at odds with the present goals of Congress. Congress should not over-react and in our opinion H.R. 14072 is over-reaction to the problem of declining Federal Reserve membership. This could be easily corrected by Federal Reserve action to lower the reserve requirements of member banks and competitive pricing of the services. Such action could be phased in over a period of time with little or no effects on monetary reaching effects on our economy without considering all other alternatives most thoroughly.

Sincerely,

MERLE D. COURSON,
Executive Vice President.

INDEPENDENT BANKER'S ASSOCIATION OF AMERICA,
September 14, 1978.

Hon. HENRY S. REUSS,
Finance and Urban Affairs
Washington, D.C.

DEAR CHAIRMAN REUSS: On behalf of our membership I comment you for your leadership in bringing H.R. 14072 through committee today in the face of formidable opposition from some members of the banking community.

Your continuing efforts to achieve an equitable solution to the problem of monetary control and competitive equality within our industry is greatly appreciated and we salute you.

Best personal regards.

IVAN D. FUGATE,
President.

LLOYDS BANK CALIFORNIA,
Los Angeles, Calif., September 21, 1978.

Hon. HENRY S. REUSS,
Chairman, Banking, Finance and Urban Affairs Committee,
Rayburn House Office Building, Washington, D.C.

I would like to submit the following coments in opposition to that portion of the legislation you are considering (H.R. 14072) which in its current form would require mandatory reserves from State chartered banks which are not members of the Federal Reserve.

First: The mandatory reserve provision would have a substantial adverse effect upon the earnings of Lloyds Bank California. For instance, as we understand the proposed legislation, and after giving full effect to the reserves we are currently required to maintain and vault cash, Lloyds Bank California would be required to maintain $51 million in nonearning reserves with the FED by the end of the three-year phasein period. At an 8 percent earnings factor this would deprive LBC of over $4 million per year in pretax earnings.

To put that figure in perspective our pretax earnings for the past 5 years have been: 1977, $11.2 million; 1976, $7.0 million; 1975, $7.1 million; 1974, $10.1 million; 1973, $6.5 million.

Although our pretax earnings are increasing during 1978 the $4 million loss of earnings on the $51 million of nonearning reserves would constitute a substantial adverse impact.

Second: $16 million of the $51 million are additional reserves over and above present requirements and would not be available for us to lend to customers with the resultant loss in business activity and jobs.

Third: I believe current State chartered non-Fed members will most likely change to national charters if they are required to keep the reserves proposed with the Federal Reserve Board. This in turn would cause a substantial adverse impact to the income of various State banking departments and would cause irreparable impairment to the dual banking system which has served this country so well for so long.

Fourth: Although Lloyds Bank California has not been a member of the Federal Reserve it has voluntarily filed numerous reporting forms giving them all information they have ever requested including the following: FR–416B—monthly; FR–416A—weekly; FR–416—weekly; FRU–4A—annually; FR–571—monthly; FR–886A—monthly.

Moreover copies of the FDIC call reports prepared by Lloyds Bank California are forwarded to the Federal Reserve Bank in San Francisco Quarterly. We have also supplied the Federal Reserve Board substantial volumes of information in response to various surveys they have conducted, such as the nonmember bank special reservable liabilities report, the survey of capital notes and debentures outstanding of insured commercial banks (June 30, 1971), and confidential report for monthly banker's acceptance survey for June 30, 1968.

In addition Lloyds Bank California was requested in August of 1973 to voluntarily comply with a marginal reserve requirement introduced by the Federal Reserve Bank for control over purchased money in the form of large domestic or Eurodollar time deposits. Although the State banking department did not make a similar change to its reserve requirements we nevertheless complied voluntarily. In short we have always responded affirmatively to all requests for cooperation and information from the Federal Reserve Board. But Lloyds Bank California cannot afford to have an increase in its reserves to the extent proposed in the legislation with the consequent loss of income.

In view of the foregoing we urge that the mandatory reserve requirement in the proposed legislation be eliminated.

STAFFORD R. GRADY,
Chairman of the Board.

INDEPENDENT BANKERS ASSOCIATION OF NORTHERN CALIFORNIA,
Santa Rosa, Calif., September 20, 1978.

LEONARD WEIL,
President, Manufacturers Bank,
Los Angeles, Calif.

The Independent Bankers Association of Northern California, representing 85 banks, strongly opposes H.R. 14072 and its amendments. Request you state this position on September 22, 1978. Hearing in Washington, D.C.

F. D. RONTA,
President.

APPENDIX

CORRESPONDENCE RELATING TO LEGISLATIVE PROPOSALS CONCERNING THE FEDERAL RESERVE'S MONETARY CONTROL AND THE MEMBERSHIP PROBLEM

CONGRESSIONAL CORRESPONDENCE

U.S. HOUSE OF REPRESENTATIVES

COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS

NINETY-FIFTH CONGRESS

2129 RAYBURN HOUSE OFFICE BUILDING

WASHINGTON, D.C. 20515

April 27, 1978

Honorable G. William Miller
Chairman
Board of Governors
The Federal Reserve System
Washington, D. C. 20551

Dear Mr. Chairman:

Your testimony on Tuesday, April 25 before the Senate Banking Committee, suggesting that the Reserve banks may begin paying interest on reserve deposits of member banks, raises a very serious question about the extent and scope of the authority of the Federal Reserve System, as a creature of Congress, to change the use of Reserve bank earnings without specific legislative authority. In brief, it has been the understanding of many years that the earnings of the Federal Reserve banks would be used first to pay the reasonable operational expenses of the reserve banks and the Board, second, to pay the statutory dividend on the so-called stock which member banks are required by law to hold in reserve banks, and third, to make a nominal addition to the reserve banks' earned surplus account, with the entire residue of earnings being returned to the Treasury. The manner in which such a distribution of gross earnings has been referred to in Federal Reserve testimony, as for example in opposing legislative proposals in past Congresses to extinguish interest-bearing Federal debt held by Reserve banks, would tend to confirm this understanding.

A more recent confirmation is evinced, we think, by the Federal Reserve's support of the Administration Bill in the current Congress authorizing the payment of interest on reserve deposits. It seems to us that Treasury and Federal Reserve support of this legislation constitutes an admission that in the absence of specific authorization, the payment of interest on reserve deposits would, at a minimum, be legally questionable. While the amounts involved in your proposal may be small in a purely relative sense, the precedent could be of enormous significance because it may be interpreted to stand for the proposition that the amount of such payments would be discretionary with the Board of Governors.

We request a clarification of your position on this issue at the earliest possible time.

Sincerely,

Henry S. Reuss
Chairman

Fernand J. St Germain
Chairman
Subcommittee on Financial Institutions Supervision, Regulation and Insurance

Parren J. Mitchell
Chairman
Subcommittee on Domestic Monetary Policy

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

G. WILLIAM MILLER
CHAIRMAN

May 5, 1978

The Honorable Henry S. Reuss
Chairman
Committee on Banking, Finance and Urban Affairs
House of Representatives
Washington, D. C. 20515

The Honorable Fernand J. St Germain
Chairman
Subcommittee on Financial Institutions
Supervision, Regulation and Insurance
Committee on Banking, Finance and Urban Affairs
House of Representatives
Washington, D. C. 20515

The Honorable Parren J. Mitchell
Chairman
Subcommittee on Domestic Monetary Policy
Committee on Banking, Finance and Urban Affairs
House of Representatives
Washington, D. C. 20515

Dear Chairmen Reuss, St Germain and Mitchell:

Thanks for your letter inquiring about my testimony before the Senate Banking Committee on April 25 as to the problem of declining Federal Reserve membership. My remarks were similar to my comments before your Committee on April 10 in response to a question from Mr. LaFalce.

The membership problem is a very serious matter, and a search for a prompt solution has high priority on the Board's agenda. The ingredients to overcome the membership attrition are (1) compensation to banks on their reserve balances, (2) explicit pricing for Federal Reserve services, and (3) reimbursement to the Treasury for initial revenue losses. All this, in my view, can be accomplished directly by the Federal Reserve.

It has always been my understanding that the Federal Reserve has authority to pay interest on reserve balances, and this has been confirmed to me by our General Counsel. I have asked that a legal memorandum be prepared for you on this point, which will be sent along shortly. I am not familiar with past statements or positions that may have caused confusion in this area. Some proposed legislation has involved certain limitations on the Fed's authority to pay interest, and I can well understand how this may have developed as part of a trade-off on other issues.

In any case, there is no intention to address the membership issue without full consultation with you and other members of Congress. It is our thought to propose a comprehensive solution with ample opportunity for your comments and suggestions with the hope that a final acceptable plan can be adopted before year end.

As our work proceeds, I will keep you informed, and look forward to your counsel and support in assuring a strong and sound banking system.

Best wishes,

Sincerely,

Bill

U.S. HOUSE OF REPRESENTATIVES

COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS

NINETY-FIFTH CONGRESS

2129 RAYBURN HOUSE OFFICE BUILDING

WASHINGTON, D.C. 20515

May 17, 1978

Honorable G. William Miller
Chairman, Board of Governors
Federal Reserve System
Washington, D. C. 20551

Dear Mr. Chairman:

Thank you for your letter of May 5, 1978, in response to our letter to you of April 27, 1978.

We simply do not feel that there is anything in the Federal Reserve Act or its legislative history which would allow the Federal Reserve to compensate member banks for their reserves without specific Congressional action. Clearly, we disagree on this point and we will be happy to exchange legal research on this issue.

Much more important, however, than these legal arguments is the resolution of some of the nagging problems which are apparent concerning Federal Reserve membership, and its effect on monetary policy and bank supervision as well as the equally important questions of pricing of services and the broad question of the Federal Reserve System's handling of funds that come under its control.

From our discussions with you, we have learned that you are putting together a proposal and that additional work is needed on the details. We will be anxious to see the Federal Reserve's final proposal in this area. Once this is available, I trust that it will be submitted to us and that we can proceed on hearings on this package along with pending legislative efforts covering the same subject matter.

Therefore, we urge that the Federal Reserve not attempt to take action to pay interest on reserves until such time as these hearings are conducted and the Congress has an opportunity to make a final decision. We, in turn, will withhold the scheduling of hearings until the Federal Reserve has had a chance to structure and polish its proposals.

Once again, Mr. Chairman, we think the Federal Reserve and the Congress both want to see these questions fully aired and resolved without inordinate delay.

Sincerely,

Henry S. Reuss, Chairman

Fernand J. St Germain, Chairman,
Subcommittee on Financial
Institutions Supervision,
Regulation and Insurance

Parren J. Mitchell, Chairman
Subcommittee on Domestic
Monetary Policy

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

G. WILLIAM MILLER
CHAIRMAN

May 31, 1978

The Honorable Henry S. Reuss
Chairman
Committee on Banking, Finance and Urban Affairs
House of Representatives
Washington, D. C. 20515

The Honorable Fernand J. St Germain
Chairman
Subcommittee on Financial Institutions
Supervision, Regulation and Insurance
Committee on Banking, Finance and Urban Affairs
House of Representatives
Washington, D. C. 20515

The Honorable Parren J. Mitchell
Chairman
Subcommittee on Domestic Monetary Policy
Committee on Banking, Finance and Urban Affairs
House of Representatives
Washington, D. C. 20515

Dear Chairmen Reuss, St Germain and Mitchell:

Following up on our recent correspondence and discussions, I appreciate your letter of May 17 with respect to procedures for dealing with the Federal Reserve membership problem.

While the matter comes up because of continuing attrition in Federal Reserve membership, our concern also is for fair competition and equal burden within the banking system. Only with the principle of equal treatment will the banking industry be able to meet the challenges ahead and assure effective and efficient service to consumers, businesses and other institutions.

As the Federal Reserve Board develops a program toward this end, I will be pleased to keep you advised and will look forward to working with you to promote solutions which will maintain a vital and healthy banking industry. I also welcome your plans to hold hearings on the Board's proposal.

Best wishes,

Sincerely,

Bill

United States Senate

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS
WASHINGTON, D.C. 20510

June 5, 1978

Honorable G. William Miller
Chairman, Board of Governors
Federal Reserve System
Washington, D.C. 20551

Dear Mr. Chairman:

There have been confusing and conflicting discussions between officials of the Federal Reserve Board and members of Congress concerning the Board's desire to pay interest on reserve balances kept at the Federal Reserve banks by member banks. It is not clear whether the Board intends to seek legislative authorization for these payments or whether it intends to proceed without specific statutory approval by the Congress. We are also puzzled over what appears to be a constantly shifting rationale behind the proposal for paying interest on reserve balances. At times, the Board has stressed the need to retain members in the Federal Reserve System for the purpose of maintaining adequate control over the monetary aggregates. At other times, the Board has emphasized the need to protect the safety and soundness of the banking system by keeping banks within the regulatory jurisdiction of the Federal Reserve System. Your most recent letter to Congressmen Reuss, St. Germain, and Mitchell dated May 31, 1978 advanced still another explanation behind the interest on reserve balances proposal -- the need to maintain competitive equality between member and nonmember banks.

Whatever the primary motivation may be for paying interest on reserve balances, we want to make our position clear and unequivocal. We are totally and unalterably opposed to any plan, proposal or draft regulation which purports to authorize the payment of interest on reserve balances without specific legislative approval from the Congress. We believe unilateral action by the Board to pay interest on reserve balances would constitute a blatant usurpation of Congressional powers and would raise profound questions about the continued independence of the Fed. We can think of no other action by the Board that could do as much to undermine confidence and trust in the Board on the part of those key members of Congress who feel strongly on this issue.

In the absence of legislative limitations, the payment of interest on reserve balances, however modestly begun, could ultimately add billions of dollars to the federal deficit and could be viewed as a precedent for carte blanche authority for the expenditure of Federal Reserve bank earnings without restraint by either the Executive or Legislative branch of the government. With Reserve bank earnings now running in the neighborhood of $7 billion annually, the payment of any part of these earnings to commercial banks can be viewed as the opening wedge in a serious breach of the Constitutional power of the Congress and the President to control federal spending and determine the fiscal policy of the nation.

We are particularly concerned that the Board may be thinking of asserting an authority that is nowhere expressly contained in the Federal Reserve Act. To our knowledge, the Federal Reserve has never announced that it was planning to use this alleged authority during the 65-year history of the Board. Moreover, whatever the legal argument may be over the intent of Congress in 1913, the fact that the Board together with the Treasury specifically sought from Congress the authority to pay interest on reserve balances in 1977 would seem to settle the issue once and for all.

It has been argued that the 1977 legislation merely proscribed a statutory limitation on an authority the Federal Reserve Board already had. We find this to be an incredible reading of the 1977 legislation. There was no mention anywhere during the extensive hearings on this legislation that the Board already had the authority to pay interest on reserve balances.

In fact, the record reflects just the opposite --- that the legislation conferred a new authority on the Board that it did not have.

For example, in his statement to the Committee, Secretary Blumenthal said the legislation, S. 1664, "would permit the Federal Reserve banks to pay interest on the required reserves of member banks." (Page 14 of Senate Banking Committee Hearings on S. 1664 and related bills. Underscoring added.)

Likewise,the report of the Senate Banking Committee on S. 2055, the bill reported, clearly indicates it was the Committee's belief that the legislation conferred a new authority upon the Federal Reserve Board. On page 17 the report states that the legislation "...grants the Federal Reserve limited authority both to (1) lower the amount of non-earning required reserves on smaller deposits and (2) pay interest on required reserve balances maintained at Federal Reserve Banks." On page 21, the Committee's report states that "Title II also authorizes the Board to pay interest on required reserve balances maintained at Federal Reserve Banks." On page 35, the Committee's report states that "Section 202(b) authorizes payment of interest on reserve balances maintained at Federal Reserve Banks." (Underscoring added.)

At no time did spokesmen for the Federal Reserve challenge these statements on the grounds that the Board already possessed the authority to pay interest on reserve balances under the original 1913 Federal Reserve Act. To suggest now that the Board believed during the 1977 hearings on S. 1664 that it already had the legal authority to pay interest on reserve balances implies the Board engaged in a duplicitous presentation to the Congress that is totally inconsistent with the Board's excellent reputation for integrity.

We are sympathetic to the membership problem faced by the Federal Reserve System, and we can assure you that we will schedule prompt hearings on any legislative recommendations on this issue which the Board may wish to transmit to the Congress.

However, we strongly urge you to put an end to the talk that the Federal Reserve is considering to pay interest on reserve balances without legislative approval by the Congress. In our view, such an attempt to usurp the powers of the Congress would impair relations between the Congress and the Federal Reserve System for years to come.

Sincerely,

Henry S. Reuss, Chairman
Committee on Banking, Finance and Urban Affairs

William Proxmire, Chairman
Committee on Banking, Housing and Urban Affairs

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

G. WILLIAM MILLER
CHAIRMAN

June 12, 1978

The Honorable William Proxmire
Chairman
Committee on Banking, Housing
and Urban Affairs
United States Senate
Washington, D.C. 20510

The Honorable Henry S. Reuss
Chairman
Committee on Banking, Finance
and Urban Affairs
House of Representatives
Washington, D.C. 20515

Dear Chairmen Proxmire and Reuss:

Your letter of June 5 has been helpful in stating your views with respect to payment of interest on reserve balances required to be maintained by member banks with the Federal Reserve.

Let me first express regret at any confusion that may have arisen about the reasons the Board has been studying various approaches to solution of the membership problem, including the possibility of payment of interest on reserve balances. Perhaps the confusion stems from the informality of my efforts to keep you and the Banking Committees informed of our thinking during early stages of developing a plan for consideration. Actually, a number of important issues are raised by the continuing erosion of Federal Reserve membership, among which are the desirability of establishing competitive equality among banks and between banks and other financial institutions, the fundamental need to maintain safety, soundness and adequate liquidity in our banking system, and considerations of monetary policy. The Board is also mindful of the need to minimize Treasury revenue losses as a result of any program to resolve the membership problem.

In seeking a solution, the Board has been studying various approaches, such as a request to Congress for enactment of legislation requiring reserve balances to be maintained with the Federal Reserve for transaction accounts at all depository institutions -- that is, a "universal" reserve requirement. This might be limited to deposits over a minimum size.

At the same time the Board is developing a comprehensive program, the principal elements of which might include the following:

(1) Reconsideration of appropriate levels of required reserves within present statutory limits.

(2) Action by the Federal Reserve to charge for its services relating to payments mechanisms and certain other appropriate areas. This component of the program would depend upon concurrent action to provide earnings on reserve balances.

(3) Provision for some earnings to be realized by member banks on required reserves at the Federal Reserve Banks, thus helping to arrest the loss of Federal Reserve membership by relieving some of the related burdens, and also contributing to more equitable competitive conditions. Such earnings would also be provided for any other financial institutions on balances they may be required to hold with Federal Reserve Banks. The simplest method would be for Federal Reserve Banks to pay interest on required reserves, although alternative arrangements might also be considered.

(4) A commitment for the Federal Reserve Banks to reimburse the U. S. Treasury for any net loss of revenue as a result of the plan during a three-year period, after which the stabilization and growth of Federal Reserve membership and income from charges for services should substantially offset any net revenue effects.

As to payment of interest on reserves, I know of no one in the Federal Reserve System who desires or intends to usurp the power of Congress. If the Federal Reserve Banks are prohibited by present law from paying interest on reserves, then obviously this method will not be available without Congressional authorization.

On the other hand, this is a legal question, and if the Banks do have authority under present law to pay such interest, just as they have authority to pay all business expenses, then I am sure you would not suggest that the Federal Reserve forego that authority.

In any case, if your respective Committees agree with your interpretation, it would seem to be unlikely that the Board would undertake payment of interest on reserve balances in the absence of appropriate Congressional approval.

I greatly appreciate your perception of the basic problem, and your willingness to proceed promptly with hearings and with consideration of legislative action once a proposed plan is presented. As soon as a Board consensus is reached on a preliminary plan, which should be by the end of this month, it is my intention, as I indicated in earlier discussions, to review the program with each of you in detail before any official action by the Board. Any plan proposed by the Board would be published with ample time for comment from all interested parties, for full consideration by your Committees, and for any legislative action that may be required.

This matter is one of the most important banking issues faced by the Board at this time, and we are therefore anxious to work with you toward a sound solution. Your willingness to give prompt consideration to our proposals is greatly appreciated.

Best wishes.

Sincerely,

Bill

U.S. HOUSE OF REPRESENTATIVES

COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS

NINETY-FIFTH CONGRESS

2129 RAYBURN HOUSE OFFICE BUILDING

WASHINGTON, D.C. 20515

June 28, 1978

The Honorable G. William Miller
Chairman
Board of Governors
Federal Reserve System
Washington, D. C.

Dear Chairman Miller:

The Democratic Caucus of the House Committee on Banking, Finance and Urban Affairs approved unanimously on Monday, June 26, 1978, the following resolution:

> RESOLVED THAT: The Democratic Caucus of the House Committee on Banking, Finance and Urban Affairs believes that the question of Federal Reserve member bank reserves, including the payment of interest thereon, and of charges for services, are matters for Congressional legislation, not Administrative regulation. It is intended to hold thorough legislative hearings on the matter, and to invite the Federal Reserve to submit recommendations for the proposed legislation as promptly as possible.

Mr. Stanton, the Ranking Minority Member of this Committee, likewise believes that these are matters for Congressional legislation, and it is my understanding that these views are shared by other members of the Minority.

I have requested the appropriate subcommittees to take action on the necessary legislation promptly. There is already before this Committee H.R. 12706 by Mr. Stanton with twelve cosponsors. I would welcome the earliest possible submittal of any material by way of amendment to H.R. 12706 or independent legislation touching on the subject matter of the resolution set forth above.

I shall be appreciative if you will convey the contents of this letter to your fellow members of the Board of Governors Thursday, June 29, 1978 and I trust that this letter will preclude any further consideration by the Board of other proposed procedures concerning these matters which are, as stated in the resolution, strictly within the purview of the Congress.

Sincerely,

Henry S. Reuss
Chairman

Correspondence From Economists

U.S. HOUSE OF REPRESENTATIVES

COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS

NINETY-FIFTH CONGRESS

2129 RAYBURN HOUSE OFFICE BUILDING

WASHINGTON, D.C. 20515

July 15, 1978

Dean Donald P. Jacobs
Graduate School of Management
Northwestern University
Evanston, Illinois

Dear Dean Jacobs:

The House Committee on Banking, Finance and Urban Affairs will hold hearings in early August on H.R. 12706 and other legislative matters before the Committee including two proposals by the Federal Reserve System and an amendment to H.R. 12706.

The above legislation and a statement which I have delivered on the floor of the House on July 14 pertaining thereto are enclosed.

I would appreciate any comment, in writing, which you may want to submit on this legislation before August 1.

Sincerely,

Henry S. Reuss
Chairman

Enclosures

Carnegie-Mellon University

Graduate School of Industrial Administration
William Larimer Mellon, Founder
Schenley Park
Pittsburgh, Pennsylvania 15213
[412] 578 2283

Allan H. Meltzer
Maurice Falk Professor of
Economics and Social Science

August 10, 1978

Congressman Henry S. Reuss, Chairman
Committee on Banking, Finance and
Urban Affairs
U. S. House of Representatives
2129 Rayburn House Office Building
Washington, D. C. 20515

Dear Congressman Reuss:

I have long favored the payment of interest on required reserves, payment by member banks for services rendered by the Federal Reserve to the members, tying the discount rate to a market rate of interest, and improving the statistics on money. I favor the general thrust of the proposals now before the committee.

With respect to specific proposals I favor one aimed at the market rate of interest on required reserves provided banks are permitted to pay a competitive, market determined rate of interest on demand deposits and on time and saving deposits. The same permission should be granted to other financial institutions by removing Regulation Q and its extension that prohibits the payment of market determined rates of interest to depositors in thrift institutions.

I favor the Stanton proposal that requires the Federal Reserve to charge for the services it renders to banks. I interpret the proposed act as permitting competition from private institutions where applicable.

I favor, strongly, paragraph three of the proposed amendment to H.R. 12706. This change will reduce fluctuations in member bank borrowing and in the monetary base induced by the very slow adjustment of the discount rate.

I favor, also, paragraph 4 of the proposed amendment to H.R. 12706.

I would like to recommend two useful additions to the proposed legislation. If the aim of the legislation is to improve Federal

Reserve control of money, the Federal Reserve should be required to take two steps that are long overdue. One would eliminate lagged reserve requirements. The other would require the Federal Reserve to operate its monetary policy by controlling the monetary base -- bank reserves and currency -- for a closely related magnitude as is now done in Germany, Switzerland, and several other countries.

Thank you for the opportunity to comment.

Sincerely,

Allan H. Meltzer
Allan H. Meltzer
(dictated but not read)

Yale University *New Haven, Connecticut 06520*

DEPARTMENT OF ECONOMICS
Cowles Foundation for Research in Economics
Box 2125, Yale Station

August 8, 1978

The Hon. Henry S. Reuss
Chairman, Committee on Banking,
Finance and Urban Affairs
U. S. House of Representatives
2129 Rayburn House Office Bldg.
Washington, D. C. 20515

Dear Henry:

I write in reply to your letter of July 15th requesting comment on legislation with respect to reserve requirements, payment of interest on reserve balances, charges for Federal Reserve services, and other matters. I hope my comment may be useful even though I could not submit it before August 1st.

1. My strong preference is for the first Fed proposal, which would impose universal reserve requirements, the same in amount and form for member and nonmember banks. My reasons are as follows:

a) There is no justification in logic or equity for treating differently identical deposit liabilities in different institutions.

b) This proposal is the cleanest and simplest solution to the dilution of Fed control because of attrition of membership. Attrition, as everyone agrees, is due to the fact that nonmember banks are subject to less costly reserve requirements and thus gain competitive advantage. Moreover, they can use their influence on their chartering authorities to make their reserve requirements less costly still. Payment of interest on member bank reserve balances, subject to the limitations in the various proposals before you, is unlikely to arrest the drift out of the System, much less to reverse it.

c) The Congress--and, with respect, you--are too complacent about the problem attrition creates for monetary control. It is not just a matter of getting better and more frequent information from nonmember institutions. Shifts of deposit liabilities and assets between members and nonmembers, and among nonmembers, and changes in behavior of nonmember institutions free of reserve discipline, are sources of disturbance in the relationship between Fed instruments and economy-wide outcomes. They are not the only sources, but they add to the variance and unpredictability of relations

c) cont'd.
between the unborrowed reserve base or the monetary base, on the one hand, and on the other hand monetary aggregates, lending by depository institutions, interest rate structure, and economic activity. The tightness of these relations is important for monetary control, no matter what targets or indicators the central bank is employing. This is a matter on which there should be no disagreement between monetarists and nonmonetarists.

Let me make the point by going to an extreme: If no banks were subject to Fed discipline with respect to reserves, Fed open market operations and rediscounting would still allow a modicum of monetary control. But what gives Fed instruments their real bite is that the Fed is the ultimate supplier of "federal funds" for which reserve requirements create urgent demand. I urge you not to sit by complacently while this power is whittled away.

c) Congress has the constitutional power and responsibility to coin money and regulate its value. It has chosen to share this with private institutions chartered by federal and state governments. Those institutions have a great and profitable privilege, and it is not asking too much that they be subjected to sufficient discipline to make sure that their collective actions are not damaging to the national economy. Federal taxpayers should not have to bribe them to be subject to such discipline. Nearly all these institutions are federally insured and would be entrusted with few deposits otherwise. Surely uniform federal reserve requirements should apply to all federally insured institutions.

e) The Fed's first proposal appears to contain ample provision for minimizing the burden of universal reserve requirements on small institutions.

2. As the previous comment indicates, I do not favor trying to induce Fed membership by paying interest on required reserves. I recognize, however, that this may have to be done if the Congress is unwilling to enact a more suitable solution.

I do favor the payment of interest on excess reserves at a rate set by the Federal Reserve. The rate would be the same as, or somewhat below, the discount rate; the two rates would generally be moved together. This proposal is not designed to induce membership; it is not a substitute for universal reserve requirements. It is designed to improve Fed control, and specifically to make the Fed's control of the funds rate more efficient and less costly to everybody. In effect, the federal funds market among banks subject to reserve requirements would be internalized by the Fed. Banks with excess reserves would earn the rate automatically, and banks short of reserves would borrow from the Fed, perhaps with some automatic overdraft arrangement up to a limit. Bilateral deals between banks in the federal funds market would become much less necessary and frequent. I originally suggested this reform in "Towards Impróving the Efficiency of the Monetary Mechanism," Review of Economics and Statistics, Vol. XLII, No. 3, PART I, August 1960 (A Symposium: Controversial Issues in Recent Monetary Policy).

3. I oppose your proposal to index the Federal Reserve discount rate to the Treasury bill yield. I urge you not to proceed so casually to dismantle the battery of tools at the disposal of our central bank. The ability of the Fed to control basic interest rates is the fulcrum of monetary control. This does not mean that the Fed does or should peg interest rates. Even if it is operating with prime attention to monetary aggregates the central bank needs to be able to enforce its will with respect to money market rates. Discretion over the discount rate helps the Fed do so, whether by moving the rate or by making it more or less effective via open market operations.

Indexing would increase the sensitivity of interest rates with respect to excess demand for or supply of reserve assets, federal funds. Rates would move more in response to a given amount of Fed open market operations, because banks could not offset the operations by borrowing less or more at a fixed rate at the discount window. This may seem to be an advantage, but the Fed does not lack control of the money market now and is not hampered by any limits on the scale of its open market operations. The ability of banks to borrow at the discount rate, subject to the disciplines that enforce reluctance to borrow, is a useful safety valve. Moreover, indexing would also make rates move more and faster in response to random shocks from the economy--changes in loan demand, or in liquidity preferences by banks and public, or in expectations of future rates. This sensitivity would often produce results undesired by the monetary authorities. Finally, the market for Treasury bills is influenced by a number of special domestic and international factors, which in recent years have caused bill yields to be out of step with other money market and short term rates. It is not a good rate to tie the discount rate to. For example, the Treasury bill rate falls relatively when other countries purchase "dollars" in the form of bills in order to prevent a weak dollar from depreciating. Such a time might not be propitious for automatically lowering the Fed discount rate.

Sincerely,

Jim

James Tobin

JT:lh

(Dictated from Wisconsin, not read)

BENJAMIN J. KLEBANER
16 WEST 77th STREET
NEW YORK, N. Y. 10024

2 August 1978

Dear Chairman Reuss

I very much regret the delay in the forwarding of the statement you requested. However the acute budgetary situation has left us with far less than minimally-needed secretarial services at the City College.

Should you desire it, I would be pleased to testify in person before your Banking Committee.

Sincerely,

Benjamin J. Klebaner

Proposed Reserve Requirement Legislation
Benjamin J. Klebaner, Professor of Economics
The City College of the City University of New York;
Regional Economist, Second National Bank
Region, Office of the Comptroller of the Currency*

* The opinions expressed in this paper are those of the author, and in no way should be construed to represent those of the Office of the Comptroller of the Currency.

Legal reserve requirements first appeared on the world scene in several American states already before the Civil War. Reserves have been required of National banks since 1863, and of banks belonging to the Federal Reserve since the system began its operations in 1914. The persistence of state-chartered banks in the face of the tax which wiped out their bank note-issuing power, and Congress's refusal in the mid '30's to sustain its 1933 decision to compel all FDIC-insured commercial banks to join the Federal Reserve System, created the current situation: banks have been free to choose the less onerous reserve requirements of the various states.

The Board of Governors has repeatedly requested legislation which would subject all insured commercial banks to its reserve requirements, since 1949. The principle has been endorsed by prestigious bodies: in 1961 by the Commission on Money and Credit appointed by the Committee for Economic Development; in 1963 by The President's Committee on Financial Institutions (chaired by Walter Heller); and in 1971 by The President's Commission on Financial Structure and Regulation (headed by Reed O. Hunt). The Hunt Commission also recommended adherence to Federal Reserve requirements for all savings and loan associations and mutual savings banks offering third-party payment arrangements. The Board of Governors had urged that all financial institutions with deposits subject to withdrawal by check be subject to the Fed's reserve requirements in May, 1971. The concept embodied in H.R. 13476 has thus been in the air for some years.

Meanwhile membership in the Fed never exceeded the 52% of insured commercial banks reached in 1945, while their deposit share never went beyond the 89% of 1942. The member bank share of total deposits has dropped from 82.9% in 1965 to 72.8% by the end of 1977. Withdrawals from the system account for only part of the decline in these years. The bulk of the drop is traceable to the more rapid growth of nonmember banks, both long-existing and newly-chartered.

In the late 1950's, the Fed viewed the monetary policy implications of the fact that nonmembers had about one-sixth of the nation's commercial bank deposits as "not serious." Even the subsequent decline in member bank share to 73% is not critical from the standpoint of effective monetary policy - making, in the view of President Volcker of the Federal Reserve Bank of New York. Nevertheless, as Professor James Tobin stated in 1977, membership attrition "is a serious matter, a threat to the effectiveness of monetary control." Volcker candidly told the Senate Banking Committee:" I do not know the point at which declining membership - and the consequent contraction of the area of direct Federal Reserve control over the money supply - would undermine our effectiveness." He quite rightly added, "Neither do I want to find out after the fact."

Shortly before joining the Board of Governors, Henry C. Wallich argued that monetary policy operations could be conducted "quite well" without required reserves. Earlier, the Hunt Commission Report had pointed out that reserve requirements were unnecessary for effective control of the monetary base by open market operations " so long as a reasonably stable proportion of deposits are held by banks for clearing and transactions purposes." Nevertheless the Commission recommended Federally imposed reserve requirements to "somewhat improve the ability of the Federal Reserve to manage the money supply."

Professor Carson (who had proposed the abolition of reserve requirements in a 1964 article), conceded in 1972 that this would "almost certainly increase the instability of the [deposit] multiplier and make control of the money supply more difficult." Weighing this cost against the costs of inefficient bank portfolios imposed by reserve requirements, Carson now favored a low, uniform reserve requirement (say 7% on demand deposits).

The Fed's monetary control could be improved by a number of measures, even without uniform reserves. For that matter, as Professor Phillips and Robertson argued in 1973, a large number of variables affect the money supply process. When they wrote: "Nor does it make any difference for purposes of monetary control that a slowly decreasing proportion of commercial bank assets and deposits fall under the direct control of Federal Reserve," they surely did not anticipate the 4.5 percentage point drop from year-end 1973 to year-end 1977. This represents an average annual shrinkage of 1.125 percentage points during those four years, compared with a .75 percentage point decline from 1969 to 1973, and a .65% drop from 1965 to 1969. The post 1973 acceleration must have added to the already significant complications cited by them of (1) the varying time lags between policy actions and their economic impact, and (2) imperfect forecasts. The departure of member banks complicates monetary control, as Professor Duesenberry has testified.

Opponents of federally-established reserves cited Professor Starleaf's findings for the 1961-73 period which appear to support the view that the precision of the Fed's control was not diminished by the absence of these requirements. In 1977, however, he stressed that his data might be unrepresentative and that to a large extent his results were traceable to the Fed's much criticized lagged reserve accounting system. Without lagged reserves, Professor Starleaf is confident that his results "would have been consistent with the proposition that base money reserve requirements enhance the ability of the monetary authorities to control the money stock."

Even in the absence of legal requirements, banks would keep some cash reserves. However, statutory requirements make for greater certainty on the part of the monetary authority. Should Congress legalize the payment of interest on demand deposits, correspondent balances are likely to shrink. Fees are expected to become more important in correspondent banking, though they have not yet replaced balances as the usual method of compensating correspondents for services. Fees are now paid for such services as EDP, financial planning, and portfolio reviews. As more and more banks unbundle their services and charge for each separately, there will be greater uncertainty in regard to the nonmember deposit multiplier, at least during the long period of transition.

A 1978 analysis concludes that "theory suggests that nonmember banks are currently a source of slippage in the Federal Reserve's control of the money stock." Given current emphasis on M1, M2 and M3 in monetary policy, this weakness calls for the remedy of federally-mandated reserve requirements.

Partly in response to the member bank slippage of recent years, the Fed has not increased any category of reserve requirements for demand deposits since July 1973, and for time deposits since December, 1974. There may be situations when an increase would be more appropriate than a sale of securities in the open market, but this instrument is unlikely to be available as long as nonmembers are exempted.

Chairman Reuss would remove the statutory power which the Board of Governors has had since 1935 because "The conduct of monetary policy through changes in reserve requirements is clumsy and imprecise." However, requirements could be raised by a fraction of one percent at a time, making them less clumsy. As for imprecision, all instruments of monetary control share that weakness. It would be a mistake to eliminate the Board's power to vary requirements, even if only a standby control.

Reserve requirements are uppermost in the minds of bankers considering the burdens of Fed membership. Although every state except Illinois has statutory requirements, 6 of the 49 permit reserves to be kept entirely in interest-earning assets. A majority (26 States) permit at least some in that form. Moreover, almost half permit uncollected cash items to count as reserves. Except for Federal Reserve float, member banks cannot count uncollected items, or keep any legally required reserves in earnings assets. A measure of the non-restraining nature of state requirements is a comparison of all nonmembers with Illinois nonmembers (the latter having only voluntary reserves). As of mid-1973, Illinois nonmembers with deposits under $25 million held cash assets 92-96% as large as all nonmembers, and for Illinois banks with more than $25 Million, the holdings were almost 100% (or over).

Not to be ignored is the fact that state enforcement of reserve requirements is much less restrictive. Thirty states have no monetary penalties for nonmember deficiencies.

The net reserve burden for member banks under $100 Million in size, is the income from about 3% of deposits; for larger banks,($100 - $1000 million) it is about 2%. In four south-western states the income sacrificed was estimated to be that available from 2-4% of deposits.

Most scholarly investigations have found that the Fed's reserve requirement has had an adverse impact on member bank earnings. A Board of Governors' 1977 Staff Study estimated the total to be around $500 Million, after allowing for Fed services and benefits. The Fed does greatly facilitate the role of member banks as correspondents for other commercial banks, but as of mid-1975, 56% of all members had no balances due to commercial banks.

Unless something is done to remedy current inequalities, the intensified squeeze on earnings felt by most members will drive increasing numbers out of the system. Although membership has not been profitable for a long time, for very many inertia and habit kept these banks in the fold. Profit pressures will lead many to reconsider their affiliation. A study of banks which withdrew during 1963 - 69 found a not insignificant 1.9 percentage point gain in their rate of return on capital, when factors other than member status were held constant.

New England banks have felt the squeeze, as thrift institutions vigorously compete with NOW accounts. Member banks had 75% of New England deposits at the end of 1974, but only 63% by the end of May 1977. One of the larger withdrawals was that of the historic First New Haven National Bank, which relinquished charter #2, dated June 1863. In July 1977, Chairman Burns told Senator Proxmire that there would be "a flood of membership withdrawals in the event that nationwide NOW accounts are authorized.

A major reason why many more banks have not yet withdrawn is the tie-in arrangement which prevents a National bank from leaving unless it converts to a state charter. The overwhelming majority of National banks have been very reluctant to leave the supervisory orbit of the Comptroller of the Currency. Nevertheless some National banks would convert even if interest were paid on reserves with the Fed. Thus the recently-converted First State Bank of Good Thunder cited the substantial increase in the lending limit under Minnesota law, and a saving of $1,100 a year in examination fees.

State banks are given a choice, and they have for the most part never joined the Fed (Table I). Only the 7 with assets above $5 billion all belonged. Fewer than 10% of state banks in the most numerous size class (with assets from $10 - $24.9 Million) belong, and indeed only 25.6% of insured state banks with assets ranging from $100 - $299.9 million. From 1960 to mid-1977 altogether 7% of newly chartered state banks joined the system. In all size classes, 100% of National banks are members. If reserves are not federally required for all banks, should not membership be made voluntary for National banks also?

Fed membership <u>can</u> be separated from the issue of uniform reserves. Phillips and Robertson ignored this when they wrote:

> "Those who resist the notion that the U.S. economy requires a czar over all our financial institutions will resist also the proposition that all commercial banks should be under permanent Federal Reserve surveillance."

Support for the dual banking system does not preclude nonmembers continuing under state and FDIC supervisory jurisdiction while keeping reserves determined by the Fed.

Table I. State Member Banks Percentage of Assets of All Insured Commercial Banks December 31, 1976

Asset Size ($000,000)	Percentage
Under 5	4.64
5 - 9.9	7.19
10 - 24.9	9.78
25 - 49.9	12.80
50 - 99.9	17.07
100 - 299.9	25.61
300 - 499.9	44.64
500 - 999.9	54.29
1000 - 4,999.9	54.55
5000 or more	100.0

Source: FDIC, Annual Report 1976, p. 227.

Table II. Proportion of Member Banks to All Insured Commercial Banks in Size Group

Asset Size ($000,000)	Percentage	Asset Size ($000,000)	Percentage
Under 5	18.7	100 - 299.9	66.3
5 - 9.9	25.5	300 - 499.9	78.6
10 - 24.9	38.0	500 - 999.9	85.2
25 - 49.9	48.9	1,000 - 4999.9	86.0
50 - 99.9	58.5	5,000 or more	100.0

Source: FDIC, Annual Report 1976, p. 227

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DEPARTMENT OF ECONOMICS BERKELEY, CALIFORNIA 94720

July 31, 1978

Representative Henry S. Reuss
Chairman
Committee on Banking, Finance
and Urban Affairs
U.S. House of Representatives
2129 Rayburn House Office Bldg.
Washington, D.C. 20515

Dear Henry:

In response to your letter of July 17, I am happy to offer my comments on the several proposed bills concerning Federal Reserve membership, payment of interest on reserves and charging for Federal Reserve services.

I find the two Federal Reserve proposals to be unacceptable. The first bill H.R. 13476 would solve the "membership problem" by making it more expensive to be a nonmember than a member. All depository institutions would face the same Federal Reserve reserve requirements on transactions accounts but only member institutions would have access to Fed services, including the discount window. Since banks would have the same reserve costs irrespective of whether they were a member or not, nonmembers would have incentive to become members to have access to Fed services. Nonbanks would simply be stuck. This approach makes no sense. If the membership problem means more than the Fed's fear of losing political power by having "relations" with a declining number of banks, it must mean that there is a danger that too large a proportion of deposits is not subject to reserve requirements and, therefore, the Fed's control over money and credit is weakened. The Fed doesn't need members to have this control, it needs (perhaps) reserve requirements. Let's grant for the moment that the Fed needs more deposits under reserve requirements. It would be more attractive in this case to have universal reserve requirements, with exemptions for small banks, and with <u>all</u> depository institutions allowed to partake of Fed services, including the discount window. In a world of universal reserve requirements, membership is a 5th wheel that does nothing for monetary policy. Of course, if all Fed services were available to nonmember institutions, there would be little incentive to be a member, which is fine with me, so long as there are reserve requirements for nonmember institutions.

That brings us back to the question of the need for reserve requirements. First, there is no evidence that I have seen to support the argument that the loss of membership has injured the Fed's ability to execute monetary policy. Theoretically, there can come a point at which such a small percentage of total deposits in the nation is subject to reserve requirements that the Fed's ability to execute policy is weakened. There is no way to estimate how great the weakening would be, even if no deposits were subject to reserve requirements. There is reason to believe that the "multiplier" relations between the monetary base, or reserves, and the volume of deposits and credit would be more difficult to predict when a smaller proportion of deposits is subject to reserve requirements. There is no way to estimate how much more difficult to predict these relationships would be.

If there is a potential problem from the shrinking proportion of deposits subject to reserves, and many responsible observers believe there is, it is much more likely to come from future growth in transactions accounts, other than demand deposits, issued by all depository instiutions. The Fed proposes to impose lower reserve requirements on these accounts than on demand deposits. This makes no sense to me. The Fed seems to be arguing implicitly that the reserve requirement is too high on demand deposits. If this is the case, then lower the requirement on demand deposits; that will help the membership problem! I was pleased to see that this inconsistency was addressed in the proposed amendments to H.R. 12706.

H.R. 12706 with its proposed amendments is quite attractive to me. I believe that the Fed should charge for its services; the proposed bill should help produce a rational system that does not unfairly compete with private sellers of similar services. I do believe that the discount window should be "priced" along with other services. It is currently at a subsidy rate, in part as an effort to recruit new members. The discount rate should move automatically with market interest rates, but I do not favor using the T-bill rate for this purpose. The Federal funds market provides an accurate measure of the cost of reserve funds, and should be used as the cost of the discount window. The bill rate typically is below the Funds rate so tying the discount rate to it would still allow arbitrage profits to be earned by borrowers at the window. I favor setting the discount rate in a week equal to the average Federal funds rate in the previous week. I imagine the Federal Reserve opposes tying the discount rate to a market rate on the grounds that it would be robbed of important "announcement effects" when the discount rate is changed. Such "announcement effects" make no sense to me; if the Fed has an announcement to make, let it call a press conference, it doesn't need the discount rate.

Finally, I am in favor of paying interest on reserves, if the Fed is going to charge for its services. Required reserves have the effect of imposing a "tax" on banks. Payment of interest would return part or all of the tax. If the Federal Government were running a budget surplus and if inflation were under control, I would support full interest payments on all reserves held at the Fed, as would occur in the initial H.R. 12706. Unfortunately, we are not in such an ideal situation. There are many taxes that need cutting and the reserve requirement "tax" would be low on most people's list. I think that we should follow Chairman Miller's advice to Congress and the President by reducing tax cuts in the interest of fighting inflation. I believe that the amendment to H.R. 12706 reduces the tax cut for required reserves to the proper magnitude, namely to the income earned from Fed services and the discount window.

Sincerely,

Jim

James L. Pierce
Professor of Economics

OSU

The Ohio State University

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July 28, 1978

The Honorable Henry S. Reuss
Chairman
Committee on Banking, Finance
and Urban Affairs
U.S. House of Representatives
2129 Rayburn House Office Building
Washington, DC 20515

Dear Congressman Reuss:

Enclosed is my response to your recent request regarding the various reserve requirements bills that are under consideration Thank you for asking for my opinion

Sincerely,

William G. Dewald

William G. Dewald
Professor of Economics
and Editor of JMCB

WGD/rjw

Enclosure

COMMENTS ON RESERVE REQUIREMENTS BILLS

William G. Dewald
The Ohio State University

Thank you for asking me to comment on the various bank reserve requirement proposals that are presently under consideration by the Committee on Banking, Finance, and Urban Affairs. Before I do, I'd like to mention that I've recently presented a proposal of my own that is enclosed for your information. My proposal seeks to make reserve requirements uniform for all federally insured depository institutions by lowering member bank requirement ratios and permitting depository institutions to count balances with member banks of the Federal Reserve System as legal reserves to meet requirements. It's an "if you can't beat them, join them" proposal, linking required reserves reform to the correspondent banking system. After many decades of proposals for uniform requirements having led to nothing, it is time to compromise by lowering requirements enough so that uniformity is not a burden on the average and by including balances with correspondent banks as legal reserves. The latter has been the main deterrent to Federal Reserve membership for thousands of small banks that depend on services provided by city correspondent banks that are considered by them as worth more than those provided free by Federal Reserve Banks.

I have some specific comments on the bills that you asked me about.

The Federal Reserve Bill, H.R. 13476: The Federal Reserve asks for regulatory authority not only in extending requirements to all federally insured depository institutions but also in being free to determine precisely what "transactions accounts" would be subject to requirements. Some details about defining "transactions accounts" need to be elicited from the Federal Reserve before granting such a blanket authority.

The Federal Reserve proposal would permit correspondent balances to be counted as legal reserves but it would make them very unprofitable for correspondent banks by imposing a full pass-through 100 per cent reserve requirement against balances owed to other depository institutions. In contrast, my proposal would set the requirement ratio against correspondent balances such that the quantity of money would not be affected by a redistribution of deposits or reserves among banks.

Within limits based on Federal Reserve earnings, the bill would authorize payment of interest on reserves. There is merit in this proposal but it is in fact equivalent to lowering requirement reserves ratios in terms of affecting bank profits and presumably Federal Reserve membership. Consider a very simple illustration: the required reserve ratio is 10 per cent, no excess reserves are held, capital is fixed, the interest rate on earning assets is 5 per cent, and there are no expenses other than meeting reserve requirements. A bank's profits associated with $1 of new deposits would be 4.5 cents, which represents a markdown of the rate of interest on earning assets by the 10 per cent of deposits banks are required to hold as reserves.[1/]

If interest were paid on reserves, part of the interest return banks

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1/ Increase in Profit Per Dollar of New Deposits = $\pi = (1-q)i$

$\pi = (1-.1).05 = .045$
for $q = .1$

$\pi = (1-.05)(.05) = .0475$
for $q = .05$

q = required reserve ratio

i = interest rate on earning assets = .05.

forego by holding required reserves would be restored. In my example, the Federal Reserve could pay 2.5 per cent interest on reserves to increase the return banks earn per dollar of deposits to 4.75 cents, exactly the same as if the required reserve ratio were cut to 5 per cent without paying interest on reserves.[2/] Since the equivalence of required reserve ratio decreases with interest on required reserves is perfectly general, one has to wonder why the Federal Reserve does not use its present statutory authority to lower required reserve ratios and ask for additional authority to lower requirements in those cases where the existing schedule is at the statutory minimum. Possibly the concern is that monetary control might be more difficult with lower requirements even though there is a reasonable probability that added uncertainties with respect to excess reserves holdings with interest on reserves would more than offset the effects of larger changes in money in response to changes in reserves with lower requirement reserve ratios. In any event, in my judgment, the Federal Reserve is amply endowed with instruments to control monetary growth whether interest is paid on reserves or required reserve ratios are lowered or both. I certainly support the concept of taking actions to raise bank profits by what is the equivalent of a tax cut whether packaged as interest on reserves or lower required reserve ratios.

The Stanton Bill, H.R. 13477 and the Reuss Amendment: The point I made about the equivalence of required reserve ratio decreases and interest

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2/ Increase in Profit Per Dollar of New Deposits = $\pi = (1-q)i + rq$
q = required reserve ratio = .1
i = interest rate on earning assets = .05
r = interest rate on reserves = .025
$\pi = (1-.1).05 + (.025)(.1) = .0475.$

on reserves applies to the Stanton Bill as well as the Federal Reserve Bill.

The statutory requirements ratios in the Reuss Amendment are appealing, provided the ratios are such that they are economically efficient in treating like activities the same. Unfortunately they are not in at least two respects. First, only member banks are subjected to requirements. Hence, ratios would differ by membership category. Second, the existing differential requirements by size of bank would be made permanent. It is inefficient for $100 million of deposits in one bank to be subjected to a higher marginal required reserves ratio than is imposed against the same amount deposited in several banks, conceivably all members of the same holding company. Though imposing no required reserve ratios on the very smallest banks gives the appearance of promoting economic freedom, it represents discrimination for the purpose of subsidizing (by the equivalent of a tax expenditure) the smallest banks. If they cannot operate profitably under the same regulations as larger banks, then perhaps they should be merged into larger institutions. In my opinion, this would increase economic welfare in at least two ways. First, the overall cost of banking services would decline, particularly in the 10,000 one-bank towns in the United States. Second, the regulatory morass that has been structured to keep small banks "competitive" could be disbanded.

The Reuss proposal to link Federal Reserve discount rates is a good one though it would be improved if the discount rate were set at a penalty level above the Treasury bill rate.

Finally, and perhaps most importantly, each of the various proposals would offer a considerable benefit in providing authority for the Federal

Reserve to collect information from all depository institutions. There is a burden in providing information but it is worth a lot. In so many cases, lack of information about monetary growth and its importance has caused widespread economic difficulties. Witness the horrors of the Great Depression that in some considerable part were associated with an absolute contraction in money over 1930-33 by about one-third. At the time, data about the total quantity of money were not collected. One can speculate that the Depression in the 1930's would not have been so "great" if the monetary authorities had had the information about what was happening to money.

A similar event, though involving very small magnitudes by comparison, has occurred this year. Just this past month, revised data on monetary growth became available. The data showed that monetary growth over the past year had been a lot higher than had been realized earlier. The revisions were mainly based on information gathered only every three months from nonmember banks. Would the Federal Reserve have pursued open market operations to constrain monetary growth within the target limits announced to Congress if they had the information about what was happening? I'm not sure of the answer; but nevertheless it is a good idea to provide the authorities with the necessary information to respond appropriately if they have a mind to, as is proposed.

In summary, I think required reserves reform is long past due. It is needed to improve the efficiency of the financial system and to prepare it for further major financial innovations that are enveloping the economy.

LINKING REQUIRED RESERVES REFORM TO THE CORRESPONDENT BANKING SYSTEM

William G. Dewald
The Ohio State University

Proceedings of a
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LINKING REQUIRED RESERVES REFORM TO THE CORRESPONDENT BANKING SYSTEM*

William G. Dewald
The Ohio State University

Reserve requirements are a governmental control that require financial institutions to hold cash and sometimes other highly liquid assets as a percentage of their deposit obligations. Historically reserve requirements were considered as a device to make deposits and bank notes safe for holders. Recently the conventional interpretation has emphasized requirements principally as a money and credit control device. Yet some research has tended to confirm that elimination of reserve requirements would not reduce the potentiality for monetary control very much. [1]

An argument is presented in the present paper for the existence of reserve requirements as a taxing device to reimburse the government for special services it provides financial institutions and for special market privileges that are granted by their charters. Based on this argument a proposal is made to improve the efficiency of the financial system and to eliminate existing inequities among institutions while enhancing the prospects for monetary control. What is proposed is uniform requirements for all chartered financial institutions but differential requirements for time and demand deposits and for balances due to chartered financial institutions. The proposal is designed to follow existing practices of financial institutions with respect to reserve holdings.

The existing system

Legal reserves to meet member bank reserve requirements include only vault cash and balances with Federal Reserve Banks. Nonmember banks are also allowed to count balances with reserve depository banks. Loss of this privilege is probably the principal deterrent to Federal Reserve memberships. [12,15] Some nonmember banks as well as savings and loan associations are allowed to count not only cash and

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*This paper is based on several of the author's earlier publications on the subject. [5,6,7,8,9] deposits as legal reserves but also U.S. government securities and other highly liquid earning assets. [10] Some can count cash items in the process of being collected. Mutual savings banks have no reserve requirements against deposits nor do nonmember banks in Illinois. For institutions subject to requirements, requirements are generally higher for demand than time or savings deposits. For member banks there is now a schedule of requirements ratios for demand deposits that rises in 5 steps from 7 percent to 16.25 percent depending on the amount of deposits. There is an even more complex schedule of requirements ratios for time deposits that not only depends on the amount of deposits but also on maturity and class of deposit.

Attempts to rationalize the requirements structure have been resisted successfully over the years. Uniform requirements were expected to emerge after the National Banking Act in 1863 and again after the Federal Reserve Act in 1913. The original Federal Deposit Insurance legislation in 1933 required all insured banks to become members of the Federal Reserve within three years but this requirement was first extended and finally dropped. The Douglas Committee in 1950, the Patman Committee in 1952, the Commission on Money and Credit in 1961, the Heller Committee in 1963, the Commission on Financial Structure and Regulation in 1971, and most recently the FINE study in 1976 have each recommended uniform reserve requirements. Nevertheless, resistance to reform from the various entrenched interests has been so great that basic inequities exist in the requirement structure today and in fact may be getting worse.

The strategy for reforming reserve requirements

The lesson of history is that a recommendation for uniform requirements in itself would come to naught. The approach suggested in this paper is designed to take some of the sting out of uniform standards by adapting requirements to the actual practice of financial institutions. The proposal is tailored to the peculiar financial structure in the United States with dual (state and federal) chartering and regulation of financial institutions and thousands of small banks and savings institutions tied together by a unique "correspondent banking system." Small banks and savings institutions look to large city correspondent banks for wholesale financial services such as holding reserves, collecting checks, shipping currency, lending on short term, and effecting security transactions. Largely comparable services are provided by Federal Reserve Banks. Despite the general expectation to the contrary at the time of the establishment of the Federal Reserve in 1913, the correspondent banking system has maintained dominance in providing wholesale banking services including check collections to the vast majority of financial institutions in the United States. [14]

Most banks and savings institutions are presently under some federal regulations insofar as they are members of the Federal Deposit Insurance Corporation or the Federal Savings and Loan Association Insurance Corporation. They find such insurance important to their successful operations. It is proposed to subject all federally insured financial institutions to uniform requirements standards but with a liberal definition of legal reserves to satisfy requirements and deposits subject to requirements. It is proposed to count U.S. government securities as legal reserves to meet requirements against time and savings deposits, effectively treating banks and savings thrift institutions equivalently. The key plank in the proposal is to define legal reserves to meet requirements for banks so as to include not only vault cash and Federal Reserve Balances, but also demand deposit balances with authorized city correspondent banks, as is the actual practice of most nonmember banks.

The fact is that reserve requirements for nonmember banks are not generally lower than country member bank requirements. Furthermore, as shown in Table 1, small member banks and nonmember banks in the aggregate hold remarkably similar ratios of cash assets to deposits. The deterrent that has kept well over half of the banks from joining the Federal Reserve System has been that their correspondent balances would no longer be counted as legal reserves if they joined the Federal Reserve. It would make no difference to a bank whether it held balances with a correspondent or with the Federal Reserve if the services offered were comparable. But they are not. As a result, nonmember banks are unwilling to take on the burden of meeting legal requirements with the Federal Reserve in addition to maintaining balances with correspondent banks so as to benefit from their superior services.

Why have any reserve requirements?

There is an argument of ancient vintage that reserve requirements are a device to provide central banks and governments with operating funds. Requirements provide the government with the equivalent of tax revenues from the saving in interest payments that would otherwise be paid. Essentially, financial institutions subject to requirements are forced to hold noninterest bearing cash assets which permits the government to finance its operations with less interest bearing debt than otherwise.

J.M. Keynes characterized required reserves or agreed upon "traditional" reserves as a device to compel banks to

TABLE 1

Cash Assets to Total Deposits by Class of Bank
(June 30 Call Dates)

Year and Bank Class	Reserves With Federal Reserve Banks (1)	Vault Cash (2)	Deposits with Other Banks (3)	Cash Assets (1)+(2)+(3) (4)
1973				
Large members	.0568	.0086	.0352	.1007
Other members	.0448	.0161	.0392	.1000
Nonmembers	-0-	.0134	.0830	.0964
1974				
Large members	.0520	.0067	.0344	.0931
Other members	.0454	.0164	.0388	.1005
Nonmembers	-0-	.0131	.0849	.0980
1975				
Large members	.0523	.0096	.0406	.1025
Other members	.0393	.0182	.0482	.1057
Nonmembers	-0-	.0141	.0950	.1091
1976				
Large members	.0557	.0117	.0415	.1089
Other members	.0381	.0201	.0435	.1017
Nonmembers	-0-	.0148	.0883	.1031
1977				
Large members	.0440	.0116	.0382	.0939
Other members	.0361	.0191	.0394	.0947
Nonmembers	-0-	.0145	.0989	.1134

Source: Federal Reserve Bulletin, Tables A18, A19.

> ...share part of the expense of maintaining the ultimate reserves of the System as a whole--without the existence of which the convenient practice of 'eligible' bills and 'eligible' collateral might sometimes break down. [11, p. 71]

A comparable statement appeared in the Report of the Macmillan Committee in 1931 and is presumably attributable to Keynes, who was a member of the Committee.

> Is is the idea of English banking that the joint-stock banks should agree voluntarily to maintain large reserve deposits with the Bank of England to provide the central institution with adequate resources to manage the monetary system and safely furnish the member institutions with precisely those conveniences for rapidly liquidating earning assets upon which the latter depends when determining the amount of their cash resources. [13, Section 370]

Is there any reason why requirements should be set at different levels on different classes of deposits? One reason is to protect inefficient firms from competition. But that is what is wrong with the existing structure. Economic efficiency requires that like functions be taxed equivalently. This basic principle requires that deposits in a given functional class should bear the same requirements whether issued by small or large banks, or by savings institutions or commercial banks.

Another reason for differential requirements is that there may be different costs imposed on the government with respect to different classes of deposits. Such a consideration is presumably behind the consensus that requirements be higher on demand deposits than time deposits since demand deposits function as money and presumably require special management. The most controversial issue involves the difference in requirements against interbank and other demand deposits. If there is a consensus it would be that there should be no differential, despite the fact that the relative concentration of interbank deposits in financial centers was historically the key factor on which higher requirements for central reserve city and reserve city banks was based.

Despite the weight of opinion in favor of uniform requirements on interbank and other demand deposits, a case can be made for the tradition of higher requirements on interbank demand deposits and for the differential between demand and time deposits. The central bank (under a fixed exchange rate regime of international payments) is required to hold international reserves of gold and convertible currencies in order to provide last resort loan availability to the financial system. This was Keynes' argument. If it is true that issuers of deposits in the various classes depend to different degrees on the last resort loan facility of the central bank, then it is reasonable that they be assessed differentially to cover its fixed costs.

Thus, the argument for higher requirements on interbank deposits depends on the empirical question whether interbank deposit issuers are more likely to require last resort loans. Historically, central money market banks have become the focus of any general financial crisis. Even in normal times, let alone financial crises, there is strong evidence that interbank demand deposits are much more volatile than other demand deposits, and demand deposits are more volatile than time deposits. Insofar as last resort loans are a temporary source of funds to individual borrowers to avoid costly alternative adjustments in the immediate run, there is an argument for differential requirements on interbank, other demand, and time deposits on the basis of differential costs of maintaining the last resort loan facility primarily for the benefit of large correspondent banks.

The second defense of differential requirements on deposits is that there is appropriately a different fee for different degrees of infringement on the government patent to issue money. Governments have a very profitable activity in issuing notes, base-metal coins, and deposits in exchange for goods and services. A bank charter is an inordinately valuable piece of property because it authorizes issue of deposits or notes as very close substitutes for government-issued money and usually in a market where entry of potential competitors is restricted. This theme is developed in recent theoretical writings about the wealth effect associated with money creation. There is an additional benefit to issuers of money and money substitutes to the extent that inflation imposes a tax on money holders that would to some extent be collected by financial institutions as co-issuers of money with the government.

On the basis of these considerations one can interpret reserve requirements as a device for banks and savings institutions to pay a tax for the right to encroach on and share in a government monopoly to issue standard money. The differential in requirements might then be justified on the basis of the degree of substitutability between government-issued money and deposits in the various classes. Another way of expressing the argument is in terms of the amount applicants for a charter would pay for the right to issue interbank demand deposits, other demand deposits, and time or savings deposits. In any event, the proposal would set differential required reserve ratios on interbank, other demand, and time deposits but make the ratios uniform for insured financial institutions.

Required reserves reform could enhance monetary control

The major political flaw in the 1976 Financial Reform Act [9] Bill was its failure to offer anything special to commercial banks. Their lobbying prowess is legendary, perhaps second only to that of the housing industry. Under the proposed legislation, banks would face more competition from thrift institutions; deposit rates would be more competitive on demand deposits and eventually on time deposits, too; thrift institutions would be enabled to lend in markets that have been dominated by banks, and so forth. Nonmember banks, whose growth in recent years has been substantial, would have been particularly injured since they would be subjected to Federal Reserve required reserve regulations which have been the principal detraction of membership in the Federal Reserve System. Since city correspondent banks profit from the resources they get from deposits of nonmember banks, they too could be injured by the FRA.

The most costly restructuring of the banking system, as far as nonmember banks are concerned, is probably the redefinition of legal reserves to meet requirements against demand deposits. Under the proposed FRA, nonmember banks (with more than $15 million in deposits) would be subjected to the same requirements ratios on deposits as member banks and, most important, they could satisfy those requirements only with vault cash or reserve deposits at Federal Reserve Banks. Proposals for uniform reserve requirements and banking regulations generally have floundered on this approach for decades. Whatever the reasons, it is time to conclude that dual bank chartering and the correspondent banking system are here to stay. Unless proper account is taken of the special interests of banks, there are probably not going to be uniform requirements.

As mentioned, the key to uniform requirements reform is the definition of legal reserves to meet requirements. This is far more important than setting minimum ratios which, contrary to popular opinion, are typically not much different for nonmember banks than for small member banks. [15] The existing system for nonmember banks is that commercial banks and, for savings and loan associations, Federal Home Loan Banks are legal reserve depositories. Another fact that is contrary to popular opinion is that small member banks hold substantial correspondent balances in addition to balances with Federal Reserve Banks and vault cash. The 1976 FRA Bill recast FINE [2-4] Principles to permit Federal Home Loan Banks to serve as reserve depositories for savings and loan associations after strong objections were raised to defining legal reserves for savings and loan associations, following FINE Principles, to include only vault cash and balances with Federal Reserve Banks. But, the bill was not recast with respect to the definition of legal reserves for commercial banks. That no one even considered the possibility presumably reflects the conventional view that to count correspondent balances as legal reserves for banks would constitute reserve pyramiding, reducing the Federal Reserve's ability to control money and credit. Pyramiding was a major evil which the Federal Reserve Act intended to eliminate. The concern has been ever since that Federal Reserve powers might be inadequate because of financial institutions, particularly nonmember banks, that could meet requirements if any with correspondent balances just as before the establishment of the Federal Reserve. However, there is reason to reexamine the possibility of reforming requirements to count correspondent balances as legal reserves not only for the purpose of improving the efficiency of the payments system but as it turns out, to strengthen monetary control powers simultaneously.

My proposal is to impose uniform reserve requirements by class of deposit on all depository institutions that are subject to requirements. Legal reserves to meet requirements against demand deposits would be defined to include both federal funds (currency and deposits with Federal Reserve Banks or Federal Home Loan Banks) and demand deposits with member banks. Legal reserves to meet requirements against time deposits would, in addition to federal funds and correspondent balances, include federal government securities. Member banks would be required to maintain reserves in federal funds against their deposits owed to financial institutions subject to requirements. Requirements ratios would be established for three classes of deposits: demand deposits due to financial institutions; demand deposits due to individuals, partnerships, and corporations (IPC); and time and savings deposits and shares.

Requirements ratios would be lowest on time deposits and highest on deposits of financial institutions, as is the traditional practice. It can be rationalized on the argument that additional central banking services would be needed to service institutions that were reserve depositories. For example, the respective requirements ratios could be 50 percent, 10 percent, and 5 percent on demand deposits of financial institutions, IPC demand deposits, and time deposits, respectively. Banks and thrift institutions in most classes would benefit. Nonmember bank requirements are presently about 10 and 5 percent in most states. By including government securities in the definition of legal reserves, thrift institutions have in effect not been subject to effective requirements, nor would they be. Under the proposal, small member banks would not face lower requirements ratios, but they would benefit by being effectively freed from time deposit requirements and by being able to count their correspondent balances as legal reserves.

To avoid affording banks an incentive to exchange correspondent balances to reduce effective requirements ratios against deposits of other than financial institutions, banks would be permitted to meet requirements with their own federal funds holdings at a lower requirement than the ratio applicable to correspondent balances, say one half. Given a 50 percent federal funds required ratio against demand deposits of financial institutions, this effectively means that financial institutions could provide their own city banking services by holding federal funds. The general principle is to keep the federal funds absorption ratio against IPC demand deposits exactly the same, whether a financial institution maintains its own federal funds holdings or employs a city bank as an agent to hold the federal funds against the IPC deposits. Under this proposal, federal funds absorbed in required reserves would be independent of the distribution of reserve holdings between federal funds and correspondent balances. Similarly, the total amount of demand deposits and associated earning assets of financial institutions subject to requirements would be independent of the distribution of legal reserve holdings. Though in my judgment the linkage in the present system due to different federal funds absorption ratios can be effectively offset by Federal Reserve open market operations, under the proposal, a change in federal funds would, given the currency and time deposit ratios, be associated with a unique level of potential demand deposits and earning assets of financial institutions subject to requirements.

This is illustrated by the T-accounts in Scenarios 1, 2, and 3. It is assumed that banks and thrift institutions hold no excess reserves, and that federal funds satisfy requirements for all institutions at half the ratio applicable for correspondent balances. The assumed requirements ratios against IPC deposits is 10 percent, and 50 percent against deposits due to banks and thrift institutions. Note that the total amounts of IPC deposits ($2,000), earning assets of financial institutions subject to requirements ($1,900), and federal funds held by these institutions ($100) are independent of the distribution of reserve holdings between federal funds and correspondent balances.

Kenneth J. Kopecky has suggested generalizing my example to insure that the level of deposits of the public is unaffected by either a random public transfer of deposits among banks or a change in the desired composition of reserve assets between federal funds and correspondent

Scenario 1

City Banks Hold No Reserves of Correspondents

Country Banks and Thrift Institutions

Assets		Liabilities	
Federal funds	$ 50	Deposits, IPC	$1,000
Earning assets	950		
	$1,000		$1,000

City Banks

Assets		Liabilities	
Federal funds	$ 50	Deposits, IPC	$1,000
Earning assets	950		
	$1,000		$1,000

Scenario 2

City Banks Hold All Reserves of Correspondents

Country Banks and Thrift Institutions

Assets		Liabilities	
Balances due from domestic banks	$ 100	Deposits, IPC	$1,000
Earning assets	900		
	$1,000		$1,000

City Banks

Assets		Liabilities	
Federal funds	$ 100	Deposits, IPC	$1,000
Earning assets	1,000	Balances due to banks and thrift institutions	100
	$1,100		$1,100

Scenario 3

City Banks Hold Half the Reserves of Correspondents

Country Banks and Thrift Institutions

Assets		Liabilities	
Federal funds	$ 33 1/3	Deposits, IPC	$1,000
Balances due from domestic banks	33 1/3		
Earning assets	933 1/3		
	$1,000		$1,000

City Banks

Assets		Liabilities	
Federal funds	$ 66 2/3	Deposits, IPC	$1,000
Earning assets	966 2/3	Balances due to banks and thrift institutions	33 1/3
	$1,033 1/3		$1,033 1/3

balances. Assuming that the Federal Reserve fixes reserves and that the public randomly transfers deposits among banks according to $D_C = kD_P + \epsilon$ where D_C is deposits at city banks, D_P is total deposits of the public and ϵ is a random error, the solution for equilibrium deposits is

$$D_P = \frac{R_0 + \epsilon[q_B(1-\alpha)q_C + \alpha q_F - q_F]}{q_F k + q_B(1-\alpha)q_C(1-k) + \alpha q_F(1-k)}$$

q_F = required reserve ratio against deposits of the public backed by federal funds

q_C = required reserve ratio against deposits of the public backed by correspondent balances

q_B = required reserve ratio against demand deposits of financial institutions

α = proportion of country bank reserves held in federal funds.

To eliminate the effect of random disturbances on D_P, the term multiplying ϵ must be set equal to zero, i.e.

(1) $$q_F - q_B q_C - \alpha(q_F - q_B q_C) = 0 .$$

To eliminate the effect of changes in the desired Country bank holdings of federal funds to correspondent balances, is required that

$$\frac{\partial D_P}{\partial \alpha} = \frac{-R_0[-q_B q_C(1-k) + q_F(1-k)]}{[q_F k + q_B(1-\ )q_C(1-k) +\ \ q_F(1-k)]^2} = 0$$

which reduces to

(2) $$q_F - q_B q_C = 0 .$$

Thus, both (1) and (2) lead to the same condition. In my example,

$$q_F = .05$$
$$q_B = .50$$
$$q_C = .10 .$$

But other figures could be chosen. Suppose q_B at 50 percent is too high to allow city banks to operate profitably. One could cut it to 40 percent and either lower the federal funds required reserve ratio against deposits of the public from 5 to 4 percent or raise the required reserve ratio against deposits of the public backed by correspondent correspondent balances from 10 to 12.5 percent. There is a set of combinations of the three required reserve ratios that would keep deposits of the public unaffected by random

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transfers of deposits and reserves which would surely enhance the prospects for effective monetary control.

Conclusion

The world of banking and finance has changed a lot in the last century. The strangest feature of the financial structure in the United States is that to this day the major banks in New York and regional financial centers continue to provide the equivalent of wholesale banking services to their financial institution customers despite the existence of the Federal Reserve Banks as official central banks.

Small banks and most nonbank financial institutions likely would rely on correspondent banks to an even greater extent for their central banking services under the proposed financial structure. City banks are a most important coordinating force with respect to the large number of small financial institutions in the United States and their importance is growing. The proposal recognizes their unique role as a link between the Federal Reserve and the financial system.

The Federal Reserve would remain essential as the central reserve agency--the bank of issue. Fifty years of intermittent banking crises under the National Banking Act demonstrated that the correspondent banking system was not self-stabilizing without a central reserve creating agency. The existence of an agency to create reserves for financial institutions is critical in a banking system with inherent instabilities. Nevertheless, far too much was reformed in 1913 when the Federal Reserve was established to perform a variety of functions that private banks had performed very well, rather than solely to manage reserves and the money supply.

If as seems the case the existing mixture of free Federal Reserve services and reserve requirements is not essential for effective monetary control, the structure could be discarded to let private commercial banks provide financial services wholesale for their customers. This would let the Federal Reserve concentrate on monetary policy--manipulating the amount of federal funds by open market operations. The proposal largely leaves the correspondent banking system intact, while introducing uniform requirements on deposits by class: interbank, IPC demand deposits, and time deposits. As a vehicle for financial institutions reform, the proposal could offer banks and other financial institutions sufficiently low required reserve ratios to attract political support. Lowering business taxes is not an unreasonable proposal these days. Lowering the general level of required reserves is a comparable proposal.

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SAMUEL B. CHASE, JR.

August 1, 1978

The Honorable Henry S. Reuss
House Committee on Banking, Finance and
Urban Affairs
2129 Rayburn House Office Building
Washington, D. C. 20515

Dear Mr. Reuss:

Thank you for inviting me to comment on the proposals dealing with Federal Reserve membership and pricing that will be the subject of hearings by your committee early this month. I deeply regret that an unusually heavy workload has dictated against my preparing a detailed reply, for I feel that the subjects under review are important. Still, I hope it will be helpful to have a rather hastily assembled compilation of my views on a number of proposals that arise in one or more of the bills.

First, I would favor the proposal to tie the Federal Reserve discount rate to the Treasury bill rate. I have never understood, at least within a modern context, the argument that the discount rate should be set at the discretion of the Federal Reserve Banks. As you well know, there have been times in the past when, for one reason or another, the discount rate has not been kept in close alignment with market rates, and when the resulting "gap" has given rise to difficult problems, either of subsidizing borrowings by certain banks or of forcing a single large "catch up" increase in the rate that has tended to be misinterpreted by the market as a signal that money is being tightened. I doubt that a careful reading of history would bear out the oft-repeated proposition that the power to change the discount rate gives the Fed an important weapon for "signaling" the market in a way that enhances the conduct of monetary policy. If the discount rate moved automatically, the Fed would still have plenty of power to signal. "Fed watchers" are now alert to any signals the System wishes to transmit. Moreover, the Fed can always make public pronouncements about monetary policy that will command widespread attention.

Second, on the matter of reserve requirement legislation, I believe that some modest benefit is gained from leaving the Federal Reserve with its power to change reserve requirements within a range prescribed by law. This is because circumstances sometimes arise in which it is necessary to tighten or ease the banking system's reserve position very rapidly, and to have the increases or reductions spread across the spectrum of member banks as evenly as possible. Moreover, I do not detect from past behavior any serious misuse by the Federal Reserve of this power, and therefore see no reason to take it away.

Third, I believe that declining Federal Reserve membership is an important issue and should be addressed promptly. This is not because declining membership reduces the effectiveness of open market operations or other Federal Reserve policy instruments -- in fact, the bulk of the studies on the subject points to the contrary conclusion. Rather, the base of membership in the Fed helps to impart to the System a political independence that, irritating as it may be from time to time, has served the country well. The institution of membership, together with that of the regional Federal Reserve Banks, is a legacy of history that has taken on new meaning over the years. Although the present System is not the kind we would create if we were starting from scratch, I believe it performs well, and is consistent with the functioning of a pluralistic society. Continued erosion of Federal Reserve membership will, over time, erode the System's usefulness, both at the Reserve Banks and at the Board of Governors.

The related subject of reserve requirements -- their level and applicability -- is of course a most vexing one. Enormous political problems would be involved with any major change. Nonetheless, having pondered this matter for more than two decades, I can only conclude that a rational and defensible reserve requirement policy for the long run must impose equal reserve requirements on all types of payments instruments -- including not only deposits, but other liabilities that can be used to effect third-party transactions -- so that membership in the Federal Reserve constitutes neither an unfair burden nor a voluntary patriotic sacrifice assumed by a few.

I see no reason for such reserve requirements to be set at high levels, other than to raise revenue for the Treasury. In the latter connection, there is no reason to believe that reserve requirements on transactions accounts represent a very efficient method for raising Treasury revenue. Although lowering reserve requirements for some institutions might create "windfall" profits, that possibility is more a reflection of the antiquity of anticompetitive statutes -- especially our branching laws and government controls over interest on deposits -- than it is of the virtuosity of continuing to tax banks through reserve requirements. In any event, it seems likely that most of any savings for banks would be transmitted to customers in one way or another.

I have always been, and remain, completely puzzled by those who would impose reserve requirements on a graduated basis, whatever might be the method of implementing such a plan. I know of no acceptable economic argument for distinguishing among institutions according to size in determining the reserve requirement "tax" relative to deposits. One might sensibly argue that the burden of proof should rest on those who propose to continue -- or even strengthen -- the so-called "progressivity" of current reserve requirements.

If uniform reserve requirements are set for all transactions accounts, Fed membership need no longer be an issue. In fact, it is probable that numerous institutions would choose to join, not leave, the Federal Reserve. There would probably be a substantial shift of banks from state to national charters, but this would represent merely another episode in the movements to and from state and national charters and should not be a matter for public concern. It should be noted, however, that the importance of the FDIC as a regulator would almost certainly be diminished if uniform reserve requirements were imposed, since the number of state-chartered nonmember banks would almost surely decline sharply.

On the matter of pricing Federal Reserve services, I strongly favor the establishment of a system of prices related to costs. On the other hand, one must be suspicious of simple solutions. It will not be easy for the Fed to establish with precision its costs, and the principles on which such costs, once determined, are translated into prices deserve the utmost scrutiny if the prices are to serve their proper functions. These functions include compensating the Federal Reserve (and hence the public sector) for services provided, rationing the services, applying a "market test" to determine whether any given service is worth its cost, and promotion of healthy competition between the public and private sectors. The proposal in the Federal Reserve's bill that would allow the Fed to set prices for new services at levels that would be justified once the services were fully utilized does not seem defensible. Rather, it is a Trojan Horse, and its adoption could lead to the Federal Reserve preempting the development of practically every new form of payments system technology. A more careful approach must be worked out.

I hope that these observations will be of some assistance to you. I am enclosing a piece I wrote on the subject of Federal Reserve membership last year, with the idea that it may further clarify some of my thoughts. I wish you and your colleagues well in your endeavor to develop sensible legislation to deal with an important national problem.

Sincerely,

Sam B Chase / QK

Enclosure

A PERSPECTIVE ON THE FEDERAL RESERVE MEMBERSHIP PROBLEM AND ITS PROPOSED SOLUTIONS

Prepared for the
American Bankers Association

by
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July 29, 1977

PREFACE

This is an independent study prepared for the American Bankers Association. Responsibility for the facts and conclusions presented in this paper rests with the authors. The conclusions do not necessarily represent the views of the American Bankers Association.

Bruce W. Morgan
Samuel B. Chase, Jr.

I.

Introduction and Summary

The continuing, and perhaps accelerating, decline in bank membership in the Federal Reserve System is a serious problem, largely for practical and political, rather than economic, reasons. The fundamental issue is the ability of the System to maintain its independence in the exercise of its monetary policy responsibilities, which are an essential part of the "checks and balances" of government macroeconomic policy. It seems probable that continued substantial further declines in membership will pose a threat to this independence.

At the purely technical level, the ability of the Federal Reserve to conduct monetary policy is not an important issue. Although the predictability of responses to monetary policy initiatives may in theory vary with membership in the System, a relationship of this sort remains to be demonstrated. In fact, careful studies indicate that precise control of the monetary aggregates is not harmed by nonmembership.

The linkage between proposed remedies for the membership problem and the proposed introduction of NOW accounts nationwide also has its purely political side. Little imagination is required to perceive the advantages of tying one issue (membership) which evokes little political interest to another (NOW's) which does. Yet, it would be quite misleading to perceive the relationship only in this manner, for there seems to be no question but that the introduction of NOW accounts in New England has led many banks to undertake a thorough re-examination of their profit and cost positions. Although NOW accounts do not increase the costs of Federal Reserve membership (and in fact tend to reduce them), and although they have no direct impact on the benefits received by members from Federal Reserve Banks, they do in some cases exert very substantial pressures on earnings that induce a careful re-examination of costs. It would appear that the full extent of the impact of Federal Reserve membership on bank profits will become increasingly apparent if nationwide NOW's cut into earnings.

The purpose of this paper, then, is to analyze the various approaches that are being proposed as means of addressing the problem of declining Federal Reserve membership, including the framework within which these proposals have evolved, their underlying economic rationale, and the extent to which economic considerations might be compromised by the political. Section II examines in detail the issue of the manner in which declining Federal Reserve membership may indeed be a problem and, if so, how it is related to that of nationwide introduction of NOW accounts. Section III turns to another aspect of the issue that has come to the forefront, namely, to the impact of declining membership, and the various solutions thereto that have been proposed, on the revenues derived by the Treasury from Federal Reserve operations. Finally, Section IV analyzes the evidence that has thus far become available by which the source of the membership problem can be identified, measured, and possibly corrected.

As already suggested, the essence of the membership problem is concluded to be the independence of the Federal Reserve, and this independence is viewed as well worth preservation. The position of the Treasury, which is to establish legislative constraints on the amounts of revenue reduction that would result from any solution to the membership problem, is open to a number of serious questions. This position is patently pragmatic, yet politically very potent. In large part, it raises some complex issues that cannot fully be examined here, such as the extent to which the operations of the Federal Reserve System benefit the public at large rather than simply its member banks, and thus of how the costs of government should be recovered from the private sector.

The examination of the evidence on the costs and benefits of Federal Reserve membership concludes that the evidence, as now constituted, is grossly inadequate to serve as a justification for the types of proposals that are now current. To the extent that there is a lesson to be drawn from this evidence, it is that the more contrived the proposed solution, the less likely that it will actually be an efficient and equitable solution to the membership problem. Rather, it is clear that the present proposals, perhaps in an effort to accommodate the Treasury position, would substantially favor some banks relative to others. The consequence is that many of the existing distortions and inequities would remain. Specifically dismissed as representing acceptable solutions to the membership problem are schemes of graduated interest rates on required reserves, which are a predominant feature of most proposals, for it seems clear that the benefits and costs of membership depend upon a number of significant factors which these schemes cannot adequately take into account.

The primary point which is clear from this evidence, yet which has thus far not been emphasized sufficiently, is that the aggregate net cost, or burden, of membership to the member banks is substantial --

currently about a billion dollars of pre-tax earnings per year. This net burden represents a cost for which the banks receive no services in return, and it is essentially equivalent to an additional tax imposed on member banks. Moreover, the amount of this net burden substantially exceeds any reduction that would be permitted by any of the current proposals or that would be consistent with the position that has been taken by the Treasury.

Based on these points, it appears that the banking industry should resist the adoption of any of the current proposals, all of which are clearly contrived and may well be incapable of solving the problem of declining Federal Reserve membership. In taking this position, the industry would do well to emphasize the full scale of the underlying problem and the desirability of simple solutions. In this respect, the ABA already, and quite rightly, has taken a position favoring a uniform interest rate for all reserves. However, it must still be recognized that certain benefits of membership, in the form of free services provided to members, vary significantly among banks as well as compete with services offered by many banks themselves to other banks. The provision of these services brings about only a modest reduction in the total burden of membership, and it would be a delusion to think otherwise. The view taken here is that, if other ways can be found to reduce significantly the membership burden, the Federal Reserve should charge fees based on costs for those services.

Reserve requirement schedules currently in effect account for many of the present distortions and inequities. Given the relative relationships among the different requirement levels, such distortions and inequities increase with higher requirements. Consequently, it seems to follow that the banking industry can work towards a reduction of these distortions and inequities, as well as of the aggregate net burden of membership, by seeking a substantial overall reduction in reserve requirements. In view of the widespread concern about the impact of NOW accounts on bank earnings, as well as the concern with declining membership, the present would seem to be an opportune time to press for such changes.

Finally, perhaps the dangers of the inadequacies of the present proposals should be emphasized. Should any of these proposals be adopted and subsequently fall short of its objectives, which might well be their fate, alternatives could be proposed which would involve other types of significant shortcomings. In particular, there is always the possibility that mandatory Federal Reserve membership for all banks might be considered at some time in the future. Such a measure would not solve any fundamental problem, however, but rather would simply compound and extend the present burdens and distortions.

II.

The Decline in Fed Membership: The Nature of the Problem

The Relation Between Membership Attrition and NOW Accounts

The first question to be considered is whether it makes sense to try to deal with the Federal Reserve's membership problem in conjunction with legislation for which the primary purpose is to extend NOW accounts nationwide. The recent Federal Reserve Board Staff study, "The Burden of Federal Reserve Membership, NOW Accounts, and the Payment of Interest on Reserves,"[1/] which will hereafter be called the "Paulus study" after its principal author, John Paulus, points out that between the end of 1970 and the end of 1976, the proportion of gross deposits of commercial banks held by members fell from 80.0 percent to 73.8 percent. During the same period, 361 member banks voluntarily left the System, usually because of withdrawal, but in some cases because of merger with nonmember banks. As a result, the percentage of all commercial banks that belonged to the System fell from 42.1 at the end of 1970 to 39.3 at the end of 1976. The number of withdrawals and mergers into nonmembers was largest for smaller banks, although a significant number of banks with deposits of $100-$500 million also left the System.

The trend away from membership has accelerated recently. During the first five months of 1977, 42 banks withdrew or were merged into nonmembers, and of these, 13 had deposits over $100 million.

1/ Board of Governors of the Federal Reserve System, June, 1977 (mimeo.). Other contributors were Edward Ettin, Stephen Axilrod, James Brundy, Milton Hudson, John Williams, John DuBois, David Reifschneider, and Perry Quik, who prepared an appendix, "Nonmember Bank Reserve Requirements."

Recent withdrawals have been especially heavy in New England, largely, according to the Paulus study, because of the adverse effect of NOW accounts on profits. At least in the sense that the advent of NOW accounts forces banks to examine their costs more carefully, this observation seems reasonable. It therefore appears that Paulus is correct in asserting that nationwide NOW's would accelerate the decline in membership unless steps are taken to reduce its burdens. Chairman Burns placed great emphasis on this point in his testimony on S. 1664.

Thus, the advent of interest-bearing checking accounts is likely to make the membership problem more acute. If it is agreed that declining membership poses a real problem to the nation, there is good reason to try to deal with that problem in any NOW account legislation.

The Nature of the Membership Problem

Another fundamental question concerns the reasons that declining Federal Reserve membership is held to constitute a problem that requires a solution. It is, of course, helpful to pin down the nature of the problem before attempting to evaluate alternative possible "solutions." Most public discussions of the Federal Reserve membership problem deal with "red herring issues" and lead one to wonder if the problem is not a phenomenon in search of a rationale. This is not to say that membership is not a problem, but only that its true nature is not brought out in most public debates. It is partly for that reason that proposed "solutions" have, in the past, failed to generate much support outside the Federal Reserve itself. It is therefore useful to turn to some of the various real and imagined explanations of this problem.

The Effectiveness of Monetary Policy

For a number of years, the Federal Reserve has based its case for "solutions" to the membership problem primarily on the argument that the decline in the proportion of commercial bank deposits accounted for by Fed members makes monetary policy less precise. This argument, made by Chairman Burns on numerous occasions, and repeated in his testimony in support of S. 1664, and in the Paulus study as well, has little basis.1/

It is, of course, possible that the existence of a large and growing number of nonmember banks will endanger the effectiveness of monetary policy. An article by J. A. Cacy,2/ explaining the arithmetic of the relationship between reserve requirements and the money stock, is cited by the Paulus study in support of its assertion that "as the proportion of bank deposits at member banks declines, the linkages between bank reserves and bank credit and the monetary aggregates are weakened."3/

The Cacy article does not, however, purport to present any evidence on this point. It is, rather, an exercise in algebra that, while useful, does not permit any conclusions about facts to be drawn. It should be noted that neither Paulus nor Cacy argues that monetary policy has no

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1/ It is helpful, in considering this question, to bear in mind that although the "problem" in this case is usually defined as the Fed's ability to control the stock of money with reasonable precision, there are those, including at times the Federal Reserve itself, who do not believe that control of the money stock, however defined, is the sole, or even primary, objective of monetary policy.

2/ J. A. Cacy, "Reserve Requirements and Monetary Control," Monthly Review, Federal Reserve Bank of Kansas City, May 1976, pp. 3-13.

3/ Paulus study, p. 6.

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influence on deposits at nonmember banks.[1/] Rather, the Paulus study states that "there is substantial -- and unpredictable -- variability in the relative growth rates of member and nonmember deposits."[2/] It is important to recognize that the key word is "unpredictable," since, to the extent that the growth rate of nonmember deposits is predictable, it cannot present a problem for monetary management.

The statement about the predictability of the relative growth rates of member and nonmember deposits seems incontestable, but it is odd that the Paulus study offers no evidence from the facts that the existence or growth of nonmember banks has impeded the monetary control process in any significant way, and even more odd that it fails to recognize that numerous empirical studies, yet to be refuted, have reached an opposite conclusion.

The question of the relationship of nonmembership to the precision of monetary control, viewed in terms of empirical evidence, turns out to be very complex. There are, in fact, reasons why nonmembership could be a benefit to monetary control, and what is probably the most useful published examination of the question finds this to be the case. Specifically, Dennis R. Starleaf reports:

1/ It can, in fact, be argued that control of monetary aggregates requires only the existence of currency and the holding of reserve balances by banks, whether or not such balances are required or held at Federal Reserve Banks. The present issue is a different one; namely, the predictability of responses to policy initiatives by the monetary authorities.

2/ Ibid.

> None of the tests reported in this paper supports the contention that FRS reserve requirements are needed on nonmember bank deposits for precision in monetary control. Indeed, all of the tests indicate that . . . without nonmember banks Federal Reserve control [of the money stock] would have been slightly more unstable than it was in fact.[1/]

Although Starleaf does not go into the reasons for this seemingly strange result, at least some students of the question have found (in unpublished studies) a positive correlation between currency in circulation and the proportion of deposits accounted for by nonmember banks. This implies that, as reserves are released by shifts of deposits to nonmembers, they tend to be absorbed by increases in currency in circulation.

In the absence of any persuasive findings to the contrary, the best available information is that monetary control is <u>not</u> being hampered by nonmembership. It is difficult to believe that, if nonmembership creates a serious problem for monetary control, the Federal Reserve's impressive research arm would not have produced a number of studies bearing out that proposition.

It can be argued that, if nationwide NOW's were to hasten the departure of members, a point might be reached where the Fed's ability to control the monetary aggregates would be seriously impaired, so that this matter should not be dismissed entirely. The weight of the evidence simply makes it difficult to accord it much attention.

In addition, it ought to be noted that Chairman Burns testified that:

> The membership problem complicates the exercise of the System's monetary control in still another

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1/ See "Nonmember Banks and Monetary Control," Journal of Finance, September 1975, pp. 955-975. Quote is from pp. 974-975.

> way. At present the Board's ability to vary reserve requirements in the course of conducting monetary policy is circumscribed by the fact that any increase in reserve requirements would tend to worsen the competitive disadvantage of member banks, and thereby prompt a further erosion of membership and perhaps also some more loosening of the ties between reserves and the monetary aggregates.

There can be little doubt that increases in reserve requirements will worsen the competitive disadvantage of member banks. However, there is no apparent need for increases in reserve requirements as opposed to other methods of tightening money, as by selling securities from the System's portfolio.

Information on Nonmember Deposits. A related argument that has been made on numerous occasions is that the Federal Reserve needs more frequent and timely data on deposits of nonmember banks. The results of inquiries on this point indicate that lack of timely reports from nonmembers has indeed posed a problem for monetary policy decisions in the past by leading to substantial errors in estimates of the money stock that have not been discovered until well after the fact. This is by no means inevitable, however, for since 1976, weekly data gathered by the FDIC for a sample of banks have tended to ameliorate these difficulties. Moreover, the FDIC is commencing a reporting series for a large sample of nonmember banks that will be identical with weekly reports for member banks. These steps will undoubtedly assist the Fed in tracing developments at nonmembers and in refining its studies of whether nonmembership causes problems of monetary control.

It is noteworthy that for 1975, the Federal Reserve reported that "The effects on the narrow money stock (M_1) of the benchmark adjustments for domestic nonmember banks were small,"[1] although the effects on M_2 were considerably larger; and that for 1976:

> Only very small adjustments were required to benchmark the money stock (M_1 and M_2) to the June 1976 call report data . . . .[2]

It thus appears that the problems posed by lack of timely reports of deposits of nonmember banks is less serious than it once was, and it is noteworthy that the Fed itself appears to have dropped the matter. In any event, S. 1873 contains the following provision:

> Every depository institution . . . [that offers NOW or share draft accounts] . . . shall make reports concerning its deposit liabilities and required reserves at such time and in such manner and form as the Board may require. (Sec. 201(b)(1).)

Presumably, most nonmembers will offer NOW's, at least eventually.

<u>Stability of the Banking System and Access to the Discount Window</u>

In his prepared statement in support of S. 1664, Chairman Burns said:

> Aside from its implications for monetary control, the Board is deeply concerned about the structural weakening of the nation's banking system that is being caused by membership attrition. Nonmember banks do not, of course, have ready access to the Federal Reserve discount window; they must rely instead on correspondent banks to meet their urgent credit needs. However, banking history demonstrates that correspondent banks cannot fulfill the function of lender of last resort in periods of strong overall credit demands.

There is no question that, under present statutes and regulations, access of nonmember banks to the discount window is severely limited. In

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1/ <u>Federal Reserve Bulletin</u>, Feb. 1976, p. 82.

2/ <u>Federal Reserve Bulletin</u>, March 1977, p. 305.

certain situations, including most importantly a generalized loss of confidence in the banking system, it would probably be essential to make direct Federal Reserve credit available to nonmembers in order to prevent their failure.

Federal Reserve Banks currently may extend emergency credit to nonmembers on the collateral of U. S. Government and agency securities. Also, if the Board finds "exigent circumstances," it can (by a five-member vote) extend credit on other types of collateral to a nonmember bank. In addition, the Federal Reserve can make "conduit" loans to correspondent banks. These provisions do require special arrangements, however, and may make access to the discount window for nonmembers too cumbersome. Nevertheless, if access to the discount window is a serious problem created by nonmembership, existing statutes and regulations could be amended so as to simplify the procedures under which loans could be made to nonmembers. That is, the discount window could be made available to all commercial banks, or to all insured commercial banks, on whatever terms seemed best for the national interest. This was, of course, the original intention when federal deposit insurance was introduced, and mandatory Federal Reserve membership was made a condition -- albeit a condition that was first postponed and eventually eliminated -- for receiving such insurance.

The problem with this solution to the "problem" is that it worsens the real problem. If the discount window were made equally available to member and nonmember banks, an important attraction of Fed membership would be lost, and any other deleterious effects of membership attrition would be made more serious.

Federal Reserve Political Independence

It has for some time appeared that the root cause of the Federal Reserve's alarm is that declining membership threatens the strength of the System as an independent entity within government. Historically, much of the unique character of the Fed has derived from the activities of the twelve regional Federal Reserve Banks which are owned, at least technically, by their member banks. The boards of directors of the regional banks and their branches, along with the examination and regulatory activities, public relations programs, and research activities of the banks, all work to buttress the Federal Reserve System in resisting pressures from other parts of government, most importantly with respect to its monetary policies.

This is not the place to catalogue the various arguments relating to the desirability of Federal Reserve independence or to ponder at length the proper degree of it, but it does seem that membership attrition tends to reduce its strength, independence, and vigor. If so, and if it is agreed that a substantial weakening of Federal Reserve independence is undesirable, then it seems rather inconsequential that the "usual" arguments are not very convincing. The important thing to recognize is that the Federal Reserve is a unique institution whose basic features are worth preserving because it has, by and large, served the nation well.

Conclusions

On the basis of the foregoing discussion, one might reasonably contend that the Federal Reserve's membership problem will be "solved" if the downward trend of membership is arrested. If so, solving the problem requires neither mandatory membership nor a dramatic reversal of past trends that would bring about a marked increase in the number of member banks or the proportion of total deposits accounted for by them. Thus, a meaningful reduction of incentives of member banks to leave the system appears to make sense as a way to deal with the issue. This is, of course, the general thrust of S. 1873 and of the Administration and Federal Reserve. positions. However, one should not underestimate the practical difficulties entailed in devising a balance between the advantages and disadvantages of membership that will maintain a status quo over the long run. It remains to be demonstrated that the envisioned balance indeed exists.

III.

Alternative Approaches and the Treasury's Stake

Assuming that declining Federal Reserve membership does require a public policy response, especially if nationwide NOW's are enacted, it is important to recognize that at least most of the currently proposed solutions have important shortcomings. As is so often true, the rush of events has pushed proposals for legislation well beyond the adequacy of the information on which sound policy decisions can be made. Moreover, once a decision is made and implemented, its reversal may be much more difficult than would have been its prevention, for even ill-considered policies tend to develop constituencies for their defense.

The present haste is impelled by the possibility -- and perhaps necessity -- of tying a solution to the membership problem, which in itself has little political appeal, to NOW accounts, which have much more appeal. Three categories of solutions to declining Federal Reserve membership have been proposed at various times: (1) mandatory membership for all commercial banks; (2) reduced reserve requirements for member banks; and (3) interest payments on reserves held at Federal Reserve Banks. All three proposals imply that many banks otherwise would choose not to be members of the System, and thus that membership must entail some net cost, or burden, for at least those banks.

The first solution listed -- mandatory membership -- would increase the aggregate burden of membership, whereas the other two represent some offset to the costs of membership. The first solution also would, at least in one sense, be simplest to analyze at the legislative stage because, in and of itself, it requires no decisions on how reserve requirements or interest payments should be structured. The other two alternatives -- interest on reserves and lower reserve requirements -- contain wide arrays of different, more specific, policy alternatives, some of which would be likely to be addressed at the legislative stage even though others would be left to the discretion of Federal Reserve regulation decisions. Each approach leads naturally to questions about the nature and extent of the membership costs which it would be designed to offset. On this matter, the current state of knowledge is particularly inadequate, as will be made clear below. Before turning to an evaluation of the statistical studies, it is useful to consider the problem posed by the fact that the major limitation on the magnitude of steps that can be taken to alleviate the membership burden would appear to be the effects on the federal budget.

Treasury Revenues and Federal Reserve Membership Burdens

The Federal Reserve System had current net earnings of slightly over $6 billion in 1976, of which almost $5.9 billion was paid to the Treasury as "interest on Federal Reserve notes." Efforts to stem the exodus of member banks by reducing the costs of Federal Reserve membership are therefore of concern to the Administration if only because they may increase the budget deficit.

On the other hand, given the level and structure of reserve requirements, membership attrition lowers the appropriate level of monetary base, thereby reducing Federal Reserve earnings. For the most part, this earnings reduction shows up as lower payments by the System to the Treasury and hence increases the federal budget deficit. It is thus essential to recognize that in the absence of actions taken to reduce the burdens of membership, the erosion of Treasury revenues is likely to continue. In his prepared testimony on S. 1664, Secretary Blumenthal indicated that:

> If the present rate of attrition in membership should continue, the net cost to the Treasury of a total withdrawal of disadvantaged banks after a few years might be between $200 million and $300 million per year, according to Federal Reserve estimates, and thus in a sense the "costs" to the Treasury would be neutral if the impact on the Treasury from the payment of interest on reserves did not exceed these figures.

Chairman Burns, in his own testimony, indicated that "the Board is very mindful of the budgetary impact." Still, he urged that S. 1664 be amended to permit the Federal Reserve to pay out as much as 15 percent of the previous year's earnings because "the Board doubts that the proposed 10 percent ceiling [in S. 1664] will prove adequate." S. 1873 lowers the ceiling to 5 percent, but also provides for lower reserve requirements, especially for small banks.

The appropriate inference would seem to be that, while neither Congress nor the Administration views reserve requirements as a promising way to raise new revenue (i.e., neither favors mandatory membership or universal reserve requirements except on NOW's), holding down the revenue loss is the major constraint they would place on any plan for dealing with the membership problem. It would appear to be safe to conclude that plans that would involve reductions of substantially more than $300 million -- say, at the very outside, $500 million -- in Treasury receipts (before allowing for "recapture" through greater retention of members) may be about as much as the Administration would support.

This apparent fact of political life explains why the key players within government are zeroing in on proposals to reduce the burdens of membership that would work mainly to the relative advantage of what past history indicates is the most mobile portion of Federal Reserve membership; namely, the smaller banks. One could say that the goal is to maximize the gain from each dollar "spent" on reducing membership burdens, where the gain is measured by the number of banks or deposits (it is hard to say which) induced not to leave (or induced to join) by the new provisions.

It is at this point that the findings of various statistical studies of the burden of Federal Reserve membership come into play, for it appears that the findings of these studies -- especially the Paulus study -- provide the sole support, other than pure expedience, for the solutions now being proposed.

IV.

Statistical Studies of the Burden of Membership

There are, in fact, only four recent studies which really touch on this point.[1/] The first of these, the Kreider study for the Conference of State Bank Supervisors, has effectively been refuted by the others, particularly Knight's Federal Reserve Bank of Kansas City paper, and needs no further consideration. Of the three remaining papers only the most recent, which is the Paulus study cited earlier, is directed explicitly to the problem of devising solutions to membership attrition. All three papers contain serious shortcomings. These include (1) a relative lack of distinctions between different types of banks and banking situations, (2) the fact that their data apply only to a single point in, or short period of, time, and (3) failures to consider some of the future directions of banking, such as new funds transfer systems. All, in other words, are severely myopic. Yet, because it alone extends severely limited knowledge and research to the point of propounding policy solutions, the Paulus study is by far the most unsatisfactory of the lot.

Perspective on the Membership Problem

Only the Paulus paper makes direct reference to declining Federal Reserve membership. This phenomenon is analyzed in a decidely

1/ In addition to the Paulus study previously cited, these studies are: Lawrence E. Kreider, "Optional Affiliation With the Federal Reserve System for Reserve Purposes is Consistent With Equitable Treatment Between Banks" (Conference of State Bank Supervisors, September 1976): Robert E. Knight, "Comparative Burdens of Member and Nonmember Banks", Monthly Review, Federal Reserve Bank of Kansas City, March 1977; and Alton Gilbert, "Utilization of Federal Reserve Bank Services by Member Banks: Implications for the Costs and Benefits of Membership", Federal Reserve Bank of St. Louis (unpublished draft).

primitive way. With regard to statistical evidence, the only distinctions that are made among types of banks are by membership status and by deposit size category.

Had further distinctions been examined, there might have been an immediate recognition that the nature of the membership problem is substantially more complex than that implied at any point in the study. Time does not permit pursuing this matter at great length, but it is instructive to observe, for example, that the rate of membership decline has been substantially higher among state member banks than among national banks. Below are shown the percentage changes in the numbers of insured commercial banks in three categories between 1964 (year-end) and 1976 (mid-year):

	1964-74	1974-76
National	-1.3	0.8
State member	-26.1	-4.0
State nonmember	16.2	2.0

If declining Federal Reserve membership is indeed caused by additional costs associated with membership, it would appear that national charters, on average, provide some offset in the form of benefits that are unavailable to state member banks.[1/] There are doubtless other important factors at work as well.

The Aggregate Net Burden of Federal Reserve Membership

Possibly the most important aspect of the membership issue from the standpoint of the ABA is the near-universal presumption that Federal Reserve membership entails costs which, at least for most banks,

1/ If this hypothesis is valid, it suggests that the source of the membership problem may be a significantly more serious matter than the rate of decline. One can only speculate about the various possible advantages of national charters, which probably vary widely among different jurisdictions.

exceed the benefits. In other words, membership essentially imposes the equivalent of an indirect tax on member banks, which takes the form of the interest income foregone on much of their reserve balances. This point is important not only for those constituents of the ABA which are currently member banks, but also for nonmembers of the Federal Reserve if for no other reason but that the eventual policy solution to the membership problem might still be mandatory membership, or mandatory maintenance of reserve balances similar to those required of members, for all banks. Such an outcome would seem to be likely, in the long run, if alternative proposals to stem membership attrition fail either to be adopted, or to work if they are adopted.

All three of the more recent studies referenced above agree that Federal Reserve membership entails a significant net burden, but only the Paulus study attempts to measure its aggregate amount -- the total amount by which the costs exceed the benefits of Federal Reserve membership for all member banks.[1/] The Knight paper goes only so far as is necessary to refute the Kreider study, and consequently neither examines the earnings foregone as a consequence of membership nor estimates the aggregate burden. The Gilbert study is confined to a sample of banks in the Eighth Federal Reserve District, and therefore does not provide the basic data that might be required for aggregation, even within that District or for the brief period covered.

1/ The Paulus study actually presents two measures of net membership burden, but only one lends itself to aggregation. The other is a highly simplistic comparison of pre-tax rates of return of member banks with nonmember banks averaged over the period 1970-1976 for different size classes of banks.

One basic problem, common to all of these studies, is that bank size is the only variable that is considered as a possible determinant of membership burden. Another (which is recognized but subsequently ignored in the Paulus study) is that there are so few nonmember banks with deposits over $1 billion as to make any comparisons in that size class highly questionable.[1/]

On a purely conceptual basis, there are at least two methods by which the burden of membership might be measured. One is the earnings differential, which is treated by Paulus in an excessively simple manner and does not warrant further attention. The second entails measuring the interest income foregone on all balances held at Federal Reserve Banks and on excess vault cash, and subtracting from this the value of the services provided by the System to its member banks.[2/] Both methods require that all variables affecting earnings, such as bank size, nature of market, and local banking structure, be held constant in the comparisons. This requirement, in turn, presents serious problems of measurement and, to the extent that it is not fully met, invites spurious comparisons.

The difficulty which has caused the most severe problem, however -- conceptually and in measurement -- arises in attempting to

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1/ These two problems are probably related. Because there are so few nonmember banks with deposits over $1 billion, it is very unlikely that they are representative of the full range of other variables which have some impact on the costs and benefits of membership. Because of their relative weight in total deposits and reserves (over half of all collected reserves at Federal Reserve Banks), distortions in estimates of net membership burden in this size class will severely distort estimates of the aggregate burden.

2/ Member banks appear generally to hold more vault cash than do nonmembers. Since vault cash is included in member bank legal reserves, this is to be expected.

measure the value of the benefits of Federal Reserve membership. Careful reasoning suggests that the value of these services should not be measured without reference to the costs -- specifically, under normal circumstances, the marginal costs -- of providing them. If Federal Reserve services were priced at marginal cost, then the total charges made for them would tend to represent their market value to those who use them.

Only the Gilbert study addresses the question of benefits from Federal Reserve membership in terms of costs. The others apply a "productive balances" approach which purports to measure the reserve balances that member banks would be willing to hold at Federal Reserve Banks in order to obtain services were there no reserve requirements. The "productive balance" concept is in trouble from an empirical standpoint virtually from the start, for it involves employing a set of circumstances which are altogether hypothetical. Moreover, its adoption is an open invitation to serious errors in valuation, for it contains no reference to costs of producing the services. 1/

Consider the two categories of services that the Federal Reserve provides directly to its member banks. The first category consists of various services associated with the nation's payments mechanism, including funds transfers and the currency and coin functions. Perhaps

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1/ Failure to use costs as a point of reference introduces a host of conceptual problems. For example, all sorts of distortions in valuation will arise to the extent that the Federal Reserve System possesses a monopoly (benevolent or otherwise) in the provision of some services. Also severely distorting any approach to valuation is the fact that the price charged for incremental use of most services by member banks is zero, leading to excessive production and use of these services.

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certain minor services such as securities safekeeping could be included in this category as well. The costs to the Federal Reserve of providing these services have been estimated at about $190 million in 1975 (Gilbert, from Board of Governors data), and at $270 million in 1976 (Paulus); the sizable difference between the two figures is difficult to fathom.1/

The other category is the access of member banks to the discount window. Valuing this privilege is extremely difficult. In the first place, the discount window serves a social function insofar as it enhances the stability of the financial system, and there is no reason to suppose that member banks should be charged for that public benefit. To the extent that such access has a private economic value, it seems reasonable to argue that the value should be measured by costs -- the other interest income that the Federal Reserve foregoes when loans to banks are made, perhaps a risk factor, and the direct expenses (wages and salaries, etc.) associated with this function. At least most of these costs are commonly recovered from the borrowing banks in the form of interest payments. (To the extent that there have been periods when the discount rate exceeded the federal funds rate, the Federal Reserve presumably was offering the service at rates above costs.)

If it is assumed, then, that the costs of providing the discount function are at least roughly recovered from the banks using this service, one can proceed to derive directly an estimate of the aggregate net burden of membership from the data provided by Paulus. Specifically, the Paulus study assumes two alternative values of the interest rate

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1/ In other words, it seems unlikely that the costs of these services rose by nearly 50 percent in a single year. Gilbert is quite explicit about the components of his cost figure, whereas Paulus is not.

which represents the returns foregone by holding reserves at the Federal Reserve Banks -- 5 percent and 6.5 percent. Collected reserve balances at the Federal Reserve Banks (total balances adjusted for float) are estimated to have averaged \$24.75 billion in 1976.[1/] Thus, the total interest income foregone presumably was between \$1.238 billion (at 5 percent) and \$1.609 billion (at 6.5 percent), excluding the costs and value to the banks of using the discount window. The range for the net cost burden of membership would then be the above figures minus the direct costs of the payments services, which, at \$270 million, means a net burden before income taxes of some \$968 million to \$1.339 billion in 1976.[2/] This amounts to roughly one-sixth of aggregate pre-tax operating income of member banks.

At no point, however, does the Paulus study cite net burdens of these magnitudes. Rather, it begins by estimating (for various bank size classes) the amounts by which the average total reserves, including vault cash, of member banks exceed those of nonmember banks. The difference is held to represent a first approximation of "nonproductive" balances.[3/] The figure thus derived, had it been expressly calculated (which it was not), would have been about \$14.1 billion.[4/] At the 5 percent and 6.5 percent

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1/ Paulus, Table 8.

2/ See Paulus, p. 24, footnote 2. All burden estimates discussed here are before income taxes. These estimates of income foregone may, in fact, be too low. Because of zero-pricing of the bulk of Federal Reserve services, and consequent excess production of services, employing total costs probably overestimates their economic value.

3/ Although unstated, this procedure perhaps has some justification if it is assumed that correspondent banking is competitive and therefore that balances held at correspondent banks receive full compensation in the form of correspondent services rendered. This assumption is specifically rejected in the Paulus paper, however.

4/ Figure reconstructed from Paulus, Table 8.

interest rates referred to above, this figure implies a net burden range of \$705 million to \$917 million. These estimates, already significantly lower than the estimates previously presented, are to be found nowhere in the Paulus paper. Yet, it is at once apparent that something is being missed by the failure to address costs of providing services directly. For the remaining "productive" reserves would, assuming an opportunity cost to banks of 5 percent, earn \$583 million, more than twice the figure cited in the Paulus study as the total cost of Federal Reserve services to member banks. One problem with the approach to measurement used in the Paulus paper is that, for banks with deposits in excess of \$1 billion, there were only a handful (five) of nonmember banks to compare with members. As a result, the estimate for this group is likely to be severely distorted, a possibility acknowledged in the Paulus study.[1/] However, a much more detailed analysis would be needed to ascertain the sources of any such distortions.

As indicated, the Paulus study does not so much as pause to contemplate the implied magnitude of benefits from "productive" balances, but rather proceeds to imputing various additional benefits to membership. The more significant of these, in terms of magnitude, is a benefit purported to represent the ability of a member bank to conduct a correspondent banking business by virtue of its Federal Reserve membership and consequent access to the payments services of the Federal Reserve Banks. This benefit is alleged to have been worth "some \$175 to \$225 million"

1/ In particular, the ratios of vault cash and "due from" balances to total deposits appear too high for the nonmember banks in this size group to attribute the differential solely to membership status.

in 1976. The other benefit is purported to be the access of member banks to the discount window, which is alleged, on the basis of virtually no evidence, to permit member banks to pay lower rates of interest on large CD's, federal funds, and the like, saving them $100 million in 1976. The combination of these two factors, then, reduces the estimated range of net membership burden in 1976 from the $705-$917 million, as noted above, to about $430-$590 million.

The discount window argument should be dismissed out of hand for lack of any conceptual basis as well as evidence.[1/] The correspondent banking argument also falls short on both grounds. First, the benefits of conducting a correspondent banking business are based on the assumption that the profitability of this business can be measured by the interest earned on 25 percent of member bank "due to" balances. This percentage is taken from the Knight study, despite the fact that Knight indicates that the figure is probably too high even for the limited sample of Tenth Federal Reserve District member banks providing the data from which it was derived.[2/] The conceptual problem, of course, is that any resulting estimates have no relationship whatever to the costs to the Federal Reserve Banks of providing the payments services associated with correspondent banking by member banks. Furthermore, even considering the matter

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1/ Knight, in fact, explicitly excludes any component for the discount window from his estimates (p. 18).

2/ Knight, pp. 26-27. The estimate was based on a survey of Tenth District banks, none of which is a major money-center bank. If one simply assumed that the profitability was equal to the average ratio of profits to deposits for all banks -- for there is certainly no reason for believing that correspondent banking is unusually profitable -- the figure for 1976 would have been substantially less.

from the standpoint of benefits rather than costs, the key economic issue is the incremental (marginal) benefits of Federal Reserve services in conducting correspondent banking -- how much more profitable is correspondent banking with access to Federal Reserve services than it would be if the services were obtainable only from the private sector.[1/] But the Paulus study establishes no basis for presuming that there is any significant difference, much less for measuring its magnitude.

The Paulus study goes on to employ the same methodology for estimating the possible impact on the net membership burden of a nationwide introduction of NOW accounts. These estimates, of course, are fraught with the same types of difficulties as those already cited. Similarly, it attempts to devise schemes for paying interest on required reserves at Federal Reserve Banks that would remove some or all of this membership burden. Some aspects of this issue are discussed below. First, however, to put the matter in some perspective on an aggregate basis, it is useful to recognize that if Treasury revenue losses must be held to a maximum of, say, $500 million, then the feasible amount of relief is significantly lower than any reasonable estimate of the aggregate net membership burden. In other words, the current proposals would go only part of the way in removing the net burden of membership, and it is therefore not obvious that they would provide a solution to the membership problem by stopping the movement of banks out of the Federal Reserve System.

1/ It seems clear that because of the Federal Reserve's current pricing policies, substitution of its services by services produced in the private sector would increase the costs of conducting a correspondent banking business. The question, then, is the extent to which the increase in costs would be passed on to correspondent banking customers.

An issue of a rather different nature should be mentioned in passing. The Paulus study indicates that additional interest payments on required reserves at Federal Reserve Banks might be employed to offset the profit impact on member banks of a nation-wide introduction of NOW accounts. Such payments would only be temporary, confined to the "worst transition" period of NOW account adoption. Why member banks, as compared to nonmembers, should be favored with a special subsidy of this sort is not explained. As it happens, this proposal does not appear to be currently under active consideration, nor, on the basis of present knowledge, would it appear to warrant endorsement.

Finally, all of the above studies confine their analysis and estimates to some recent period. No one has asked how the net membership burden might have changed in the past, and particularly whether, and why, it may have increased. For example, has private correspondent banking perhaps become more efficient, possibly increasing the net burden? Similarly, there is no examination of the question of what changes might occur in the value of the services provided by Federal Reserve Banks as new technologies are adopted. Of particular importance is the future impact of electronic funds transfers and the role of Federal Reserve Banks in these funds transfer systems.

Variations of Net Membership Burden Among Member Banks

The net burden of Federal Reserve membership can be expected to vary among individual banks for a number of reasons. The size and deposit mix of a bank determine its reserve requirements, and the nature of its local market will determine the opportunity costs of sterile reserve balances. Similarly, the extent to which the services of Federal Reserve Banks are utilized will depend on a variety of factors, such as the types of payments transfers required by customers in a particular market, the convenience, availability, and costs of correspondent banking services within that market, and the banking structure of the area.1/ For example, simply the deposit functions and funds transfer needs of a rural bank are likely to be very different from those of an urban bank of equivalent size.

Yet, none of the studies cited addresses the multitude of factors other than size that are likely to influence the membership burden, although bank size is only imperfectly correlated with most of these other factors.2/ To some extent, these defects can be expected, because the studies are breaking new ground. But it appears that the findings of the Paulus study are being pushed much further than is warranted. This study correctly notes that the propensity to withdraw from Federal Reserve membership tends to increase as bank size diminishes. Particularly in view of the constraints that seem

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1/ Knight explicitly recognizes the significance of some of these variables and the limitations imposed by their exclusion from the analysis (p. 28).

2/ For example, the amount of correspondent banking activity conducted by large commercial banks varies substantially among those banks, as suggested by Appendix Table 1. It seems probable that similar investigations of other variables would also show highly imperfect correlations with bank size.

certain to be imposed on the total amounts of relief from the membership burden through interest on reserves or lower reserve requirements, it is critical to note that the methods and assumptions employed in the Paulus study seem to be strongly biased in favor of implying larger burdens for smaller banks.

Before turning to the results of the Paulus study, it may be useful to review the findings of Gilbert. That study makes it quite clear that, relative to deposits, large banks tend to obtain significantly more free services from Federal Reserve Banks than do smaller banks. But in no event do these findings indicate a degree of difference that approaches eliminating the net membership burden for large banks. Specifically, the costs to the Federal Reserve of providing such services relative to reserve balances is about three times as high among the largest banks analyzed as among the smallest. But, using Gilbert's data, and assuming that foregone interest income of member banks is 5 percent of reserve balances, the net burden for the largest banks, relative to deposits, is only some 20 to 25 percent less than for the smallest banks. Equally importantly, this study makes clear that the utilization of such services varies substantially even among banks of similar size.

Consider, now, the Paulus study, It sets the stage by comparing ratios of pre-tax income to assets among member and nonmember banks in different size categories, with the following average results over the period 1970 to 1976:

Deposit Size Class (Millions)	Earnings Disadvantage of Member Banks, before Tax (Percentage Difference) 1/
Under $10	8.2%
$10 - $50	6.1
$50 - $100	4.7
$100 - $500	2.4
$500 - $1,000	-1.0

The apparent conclusion is that the net membership burden diminishes in an essentially uniform fashion with increasing bank size and, in fact, becomes negative, implying net benefits to membership, among banks with deposits over $500 million -- an implication that is not borne out in subsequent, more detailed, analysis. Actually, other than as a device to set the stage, not much is made of these comparisons. Indeed, in view of the large number of significant variables that are not considered, the comparisons are of little value.

The ensuing analysis in the Paulus study follows the lines indicated in the earlier discussion of aggregate net membership burden. Of some interest here is what happens to the burden estimates as the highly dubious adjustments are made for the purported benefits of correspondent banking and the Federal Reserve discount window. First, consider the net burden estimates prior to these adjustments, expressed as percentages of

1/ Percentage difference in the percentage rates of return on assets. The precise method of calculation is not indicated. No figures are presented for banks with deposits over $1 billion, for there were three or fewer such nonmember banks prior to 1976. (Paulus, Table 3.)

deposits and other liabilities:[1/]

Deposit Size Class (Millions)	Net Membership Burden as Percentage of Liabilities
Under $10	2.92%
$10 - $50	2.57
$50 - $100	2.74
$100 - $500	2.36
$500 - $1,000	2.42
Over $1,000	1.85

Interestingly, the pattern is hardly uniform, which should itself be a cause for some unease. There is, moreover, very little difference over the whole range from $10 million to $1 billion. Also, as observed earlier, the figure for banks with deposits over $1 billion is particularly questionable. In any event, such results would cause a problem from a political standpoint, for they suggest that in order to remove the net burden, very large banks would need to be paid nearly as much interest relative to reserve balances at Federal Reserve Banks as much smaller banks. To do so is apparently regarded as involving unacceptable costs in terms of lost Treasury revenue.

Now consider what happens as the various adjustments are applied, with the net membership burden now measured in dollars:[2/]

1/ Paulus, Table 6.

2/ Paulus, Table 7, and derived from Table 6.

Deposit size class (millions)	Net membership burden (millions): Before adjustments	After correspondent banking adjustment	After all adjustments
Under $10	$11 - $15	$11 - $15	$11 - $15
$10 - $50	$97 - $106	$96 - $125	$92 - $121
$50 - $100	$64 - $83	$53 - $82	$60 - $79
$100 - $500	$132 - $172	$116 - $151	$103 - $138
$500 - $1,000	$82 - $106	$68 - $89	$58 - $79
Over $1,000	$319 - $145	$176 - $220	$106 - $159
Total	$705 - $917	$531 - $690	$431 - $590

The pattern is obvious -- the adjustments, which have already been argued to be improper, tend not only to reduce substantially the aggregate net burden, but also are systematically biased in terms of bank size. They in fact make very little difference for banks with deposits under $100 million, and most of their impact is on banks with deposits over $500 million, which are estimated to have held, on average, nearly 63 percent of total collected reserve balances at Federal Reserve Banks in 1976.

It is therefore hardly surprising that the Paulus study recommends that, to offset the burden of membership, highly progressive interest rate structures should be applied to required reserves. Although the legislation pertaining to interest on reserves now under consideration does not specify any particular form of graduated interest payments, it does aim at reducing reserve requirement burdens most for smaller member banks.

The proposed legislation would, within limits, leave the interest rate structure for required reserves to the discretion of the Board of Governors. If the Paulus study represents the types of inputs that are likely to be available to the Board in making decisions on this matter, then the banking industry ought to be very concerned.

Conclusions on the Empirical Evidence

The empirical evidence on the benefits and costs of Federal Reserve membership is in many respects very inadequate, but particularly so from the standpoint of devising the sorts of contrived "solutions" to the membership problem that are now under active review. Indeed, if there is a lesson to be learned from this brief review of the evidence, it is that none of the current proposals is likely to eliminate the economic distortions and inequities that are currently entailed by membership. Rather, the focus of the various measures that are now in the forefront of serious consideration is such that it seems safe to predict that the membership problem will remain in some form into the indefinite future. Although these measures would provide some relief from the current burden of membership, the relief would by no means be complete and its effects might easily be offset by other developments which force member banks to evaluate their profit positions with more care.

The fact that the present evidence makes entirely clear is that there does exist a substantial net cost burden of Federal Reserve membership. The aggregate net burden is, indeed, rather easily estimated on the basis of the Federal Reserve's cost accounting data, andit is currently some billion dollars or more annually. Of course, the amount of the burden will tend to vary over time with variations in those interest rates representing the opportunity costs of reserve funds, as well as with reserve requirement schedules and the levels of the monetary aggregates, but it seems likely that it has been increasing. Unfortunately, however, the data necessary to examine long term trends do not appear to have yet been developed. The existence of a substantial net cost burden of membership, whatever its trend, can be likened to an indirect tax imposed on member banks, although it could also be argued that, to the extent that membership is necessary to some banks in order for them to conduct their business, the net burden represents, rather, a monopoly profit to the U. S. Government.

Given the existence of this substantial membership burden, moreover, the attrition in Federal Reserve membership must be interpreted as an entirely rational economic response by the private sector. The observed process simply is one of a reallocation of capital away from a less productive -- less profitable -- use, which is banking within the context of Federal Reserve membership. There is a direct analogy to economic principles of taxation and, in particular, to the concept of tax avoidance. The process of avoidance, in turn, is suggestive of inequities and of distortions in the allocation of economic resources.

Far less clear than the existence of a substantial net cost burden is the manner in which it is distributed among Federal Reserve members. The burden does appear to be slightly "regressive" in its incidence on individual banks in the sense that, on average, it tends to be slightly larger relative to deposits for smaller banks. However, it is equally clear that there are numerous factors other than size which are also important determinants of net burden in individual cases, and that bank size is a poor proxy for at least some of these variables. It is hard to make sense out of a proposed system of payments -- essentially rebates -- to member banks with the alleged purpose of removing some or all of the burden of membership until the effects of these other variables have been more clearly identified and measured.

Yet, there remains a serious question of whether any such undertaking is warranted in the first place. Beyond the total net burden that is imposed, much of the distortion and inequity in the distribution of the burden arises from two features of Federal Reserve membership which lack any economic rationality, namely, the pricing -- or lack of pricing -- of the services provided by the Federal Reserve to member banks and the structure of reserve requirements. Moreover, because the effect of each of these peculiarities on a given bank is determined by numerous variables other than total deposit size, the distortions of one cannot typically be expected to be offset by reshaping the distortions caused by the others so as to provide even a relatively uniform pattern of distribution of the net burden among all member banks.

In the absence of rational pricing of Federal Reserve services to member banks, it is impossible to determine the amount of services that would be provided, and their costs, in an efficiently operated system. Moreover, as has been seen, the present system has altogether misled some analysts with respect to the values of these services, particularly in correspondent banking. In fact, one would expect that, within a competitive correspondent banking framework, the benefits of free Federal Reserve services would simply be passed on to respondent banks with no additional profit to the correspondents. Moreover, some of the recent studies overlook the fact that the Federal Reserve actually competes with private correspondents, its pricing policies serving to deter the private sector from providing competing services. In other words, some studies suggest that there are net benefits to banks as a consequence of a monopoly -- the Federal Reserve -- subsidizing certain services from its monopoly profits. Were such practices to occur in the private sector, they would be regarded as constituting predatory pricing.

Although rationalizing the pricing of these services would reduce the distortions entailed in their provision, it would aggravate the net membership burden caused by reserve requirements. Moreover, it is possible that such a change would increase the inequities in the distribution of this burden among banks.

The solution to the membership problem that is now in vogue is the payment of interest on reserves. This approach would, of course, reduce the aggregate net burden, but that is essentially all that can be expected. A broad question is whether such an approach, as now formulated, makes any economic sense, for it essentially constitutes giving back with one hand what is taken away with the other. It seems clear from the evidence that no interest scheme can fully remove the distortions in the distribution of the membership burden, and it might well create new distortions. Such would certainly be the case with the sorts of graduated interest rate structures of the types suggested by the Paulus study. It should be clear at this point that there is no empirical basis for such a scheme, and it is unlikely that any basis exists. Indeed, to the extent that interest payments on reserves are perceived as a viable means of alleviating the membership burden, a uniform rate on all required reserves appears to be the most reasonable from the standpoint of economic analysis.

Similar comments apply to recent proposals for selectively reducing reserve requirements, such as up to some given amount of total reserves. Again, the problem is that there would be no direct linkage between burden and the benefits of membership, and any reductions in some distortions would be accompanied by increases in others. If the question of reserve requirements is to be opened, as indeed it should, the logical approach would seem to be something rather different.

Ultimately, any economically defensible attempt to address the membership issue must confront the question of the structure and levels of reserve requirements -- a question which is not so much as raised in any of the recent studies. The present structure, based on such factors as bank size, had its origins in the early nineteenth century and was initially based on the concept of a linkage between reserves and liquidity, with the theory of control of monetary aggregates coming into being only at a much later date. There is no intention of attempting toanalyze the rationale for this structure in this paper. However, it might simply be pointed out that, to the extent that this structure does cause distortions among individual banks, the distortions will be larger the higher the levels of required reserves. For example, suppose that it is decided that the percentage reserve requirements should be twice as high for large banks as for small banks. The distortions will be substantially larger if the reserve requirements are set at, say, 14 and 7 percent than they would be at 2 and 1 percent.

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Given the virtual impossibility of removing the distortion and inequities resulting from reserve requirements by means of ancillary schemes, such as interest on reserves and pricing of Federal Reserve services, an important and altogether logical component of any approach to the membership problem would seem to include a reduction in the levels of required reserves. Ideally, this step would be complemented by the introduction of fees for services which are based on the marginal costs of their provision. Moreover, it should be recognized that, even if both of these steps were to be taken, there would remain some net burden of membership as long as any reserve requirements are retained. It is at this point that serious consideration might be given to interest payments on required reserves, with rates that are both uniform for all required reserves and, at least on average over time, reflective of market rates of interest.

What, then, are the implications for the ABA? Currently, it seems, the primary element of its position is an insistence that, should interest be paid on required reserves, it should be at a uniform rate for all reserves. The evidence would certainly suggest that the ABA is quite rightly suspicious of other, more contrived, interest rate schemes, and thus its position on this point should be retained. However, there is no apparent possibility that interest on reserves will remove much more than half of the net burden of Federal Reserve membership on member banks, at best. Consequently, the ABA should seriously consider the inclusion of at least two other proposals as part of its position, namely, a general reduction of reserve requirements and the imposition of fees for Federal Reserve services provided to banks. Notice that the last proposal, aside from making the others more palatable, need not be altogether detrimental to banking, even though it would raise costs. Rather, it could result in a shift of the supply of some of these services from the Federal Reserve to the private sector.

One possible further question might be whether mandatory Federal Reserve membership should also be included should the above proposals for reduced reserve requirements, possibly accompanied by a uniform rate of interest on reserves, and rational pricing of System services, be adopted. However, there is the danger that with universal membership the Federal Reserve might not only retain its monopoly over the services it now provides, but also extend this monopoly to other services. Universal membership would in any event be detrimental to present correspondent banking. Inasmuch as the Federal Reserve already has a negative impact on private competition in correspondent banking, there seems little point in inviting a compouding of this problem. It is easy to talk in the abstract about rational pricing systems for governmental agencies, but, in the real world, there is no substitution for the free marketplace when it is permitted to function properly.

Whereas the foregoing suggestions would provide a basis for alleviating the net burden associated with Federal Reserve membership, it seems unlikely that the burden will be removed entirely because of the impact on Treasury revenues. It might be worthwhile to note that, if recent rates of growth in the currency supply continue, the impact on the Treasury of eliminating the aggregate net membership burden would, in current dollar terms, be erased in about two years. Aside from this point, perhaps it can only be emphasized that the revenue impact of removing a highly inefficient and inequitable tax is an altogether inadequate argument for its retention.

Appendix Table 1

Deposits Due to Banks as Percentages of Total Deposits
Banks With Total Deposits Over $500 Million and
Deposits Due to Banks Over $10 Million

Percentages of total deposits	Number of Banks: Federal Reserve District 1	2	3	4	5	6	7	8	9	10	11	12	Total	Percentage of total
0 - 1.9	-	3	1	4	6	-	1	-	-	-	-	8	23	16.9
2.0 - 3.9	-	3	-	4	5	2	7	-	-	1	-	9	31	22.8
4.0 - 5.9	1	4	2	3	3	3	-	-	-	-	-	-	16	11.8
6.0 - 7.9	2	1	3	-	-	6	3	2	-	1	2	-	20	14.7
8.0 - 9.9	1	1	-	1	-	2	1	1	1	4	4	-	16	11.8
10.0 - 11.9	1	2	1	-	1	1	2	-	-	-	2	-	10	7.4
12.0 - 13.9	-	1	-	-	1	2	2	3	1	-	1	-	11	8.1
14.0 - 15.9	1	1	-	-	-	-	1	-	1	1	-	-	5	3.7
16.0 - 17.9	-	-	-	-	-	-	-	-	-	1	-	-	1	0.7
18.0 - 19.9	-	-	-	-	-	-	-	-	-	-	-	-	-	-
20.0 - 21.9	-	1	-	-	-	-	-	-	-	-	-	-	1	0.7
22.0 - 23.9	-	-	-	-	-	-	-	-	-	-	-	-	-	-
24.0 - 25.9	-	2	-	-	-	-	-	-	-	-	-	-	2	1.5
Totals	6	19	7	12	16	16	17	6	3	8	9	17	136	100.0

SOURCE: American Banker, December 17, 1976, pp. 38 ff.

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DEPARTMENT OF ECONOMICS
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July 29, 1978

Honorable Henry S. Reuss
Chairman, Committee on Banking,
Finance and Urban Affairs
U.S. House of Representatives
2129 Rayburn House Office Building
Washington, D. C. 20515

Dear Chairman Reuss:

Thank you for your letter of July 15, 1978, inviting comments on H.R. 12706 and related matters. My previous testimony on several occasions before the Senate Committee on Banking, Housing and Urban Affairs and its Subcommittee on Financial Institutions contains extended comments on the subjects of this proposed legislation. In summary, however, my views are as follow:

(a) H.R. 13476 - the proposal that mandatory reserve requirements be extended to non-member commercial banks, mutual savings banks, savings and loan associations and credit unions should not be acted on favorably. There is no demonstrated rationale for this proposal from either a regulatory or monetary policy point of view. Reserve requirements for members are currently too complex and too confiscatory, but this does not argue that all non-member deposit financial institutions should bear the same cumbersome and arbitrary requirements.

(b) H.R. 13477 and H.R. 12706 - generally, the proposal that the Federal Reserve be permitted to pay interest on reserve balances should receive favorable action. My view is not based on the so-called "membership problem." Instead it is based on the need to retain among the deposit institutions the ability to "buy money" competitively in the modern technological environment. It is needed to deter the spread of substitute, money-like liabilities of non-deposit institutions such as money market funds, corporate commercial paper, etc.

Balances at the Fed should be open to any deposit financial institution, "membership" should not be required, the rate paid should depend on money market conditions and monetary policy goals, and there should not be limitations on rates based on receipts for services rendered or the net earnings of the Fed. When "tightening" of money is required, the rate should be raised, and vice versa. Such a tool would complement quantitative controls such as open market operations. Again, membership is not the issue; voluntary choices to hold more or less of an institution's assets in central bank reserves are the key to the success of this new instrument.

The pricing of central bank services is an extraordinarily complex matter. As I perceive the Fed's interests, there is an inclination for the central bank to want to provide or require services well beyond any areas required for safety and soundness or for monetary policy. Explicit, full-cost pricing is theoretically a good answer, but one frought with regulatory details. My guess is that the Fed would have to subsidize many services quite drastically to be competitive with the correspondent banking system - unless the Fed adds regulatory requirements to its system of pricing. It is the latter which should be avoided.

I recognize that my views are not in accord with your own or with those of the Fed. If the Committee wishes more detailed comments, I will be pleased to provide them.

Sincerely,

Almarin Phillips

Almarin Phillips
Professor of Economics, Law
and Public Policy

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July 28, 1978

Congressman Henry S. Reuss, Chairman
Committee on Banking, Finance and Urban Affairs
U.S. House of Representatives
2129 Rayburn House Office Building
Washington, D.C. 20515

Dear Congressman Reuss:

This is in response to your letter of July 15th inviting me to comment on HR 12706 and other legislative proposals concerning Federal Reserve membership. The basic purpose of all these pieces of proposed legislation is to halt the loss of member commercial banks from the Federal Reserve System. This problem has haunted the Federal Reserve for a number of years, and the System has taken numerous steps, generally both inefficient and, in retrospect, ineffective, to halt the drain of member banks. Because it is at the core of the proposed legislation, it is desirable to first evaluate whether there is or is not a "membership problem" and whether the proposed cures may or may not be better than the disease.

Membership, or rather the lack thereof, is claimed to be a problem by the Federal Reserve System because it weakens the nation's financial system in a number of ways:

1) the nation's payments system is weakened as more and more "transactions are handled outside the safe channels of the Federal Reserve,"
2) fewer banks have access to the Federal Reserve discount window,
3) the "national presence" of Federal Reserve supervisory and regulatory functions becomes increasingly diluted, and
4) monetary policy is made more difficult.

In addition, the following arguments have been made by the System on other occasions to support the need for action to stop the loss of member banks:

5) equity with nonmember banks whose reserve requirements are typically lower than for member banks and some or all of which may be held in interest yielding form,
6) maintenance of Federal Reserve independence,
7) maintenance of Federal Reserve international prestige, and
8) loss of revenue to the Federal government.

At least one additional reason is often given by persons outside the Federal Reserve for the Fed's position:

9) Federal Reserve embarrassment in losing members.

Let me evaluate each one of these reasons individually.

1) While the development of a national payments system was an important objective in the original Federal Reserve Act of 1913, it is not now. The payments system is well established and operates efficiently. The introduction of EFTS occurred without much Federal Reserve influence. The Fed's role should be limited primarily to help get a new system off the ground and then get out when it is working.

2) The Federal Reserve is the lender of last resort. This responsibility is too important to be limited to only member banks. This has been recognized by the Federal Reserve and provisions already exist for lending to nonmember banks, other financial institutions, and even nonfinancial firms in periods of emergency.

3) It is questionable whether Federal Reserve examinations and supervision are better than those of the Office of the Comptroller of the Currency or the Federal Deposit Insurance Company. The latter examines all banks that surrender membership. The Federal Reserve has the smallest examination force, being responsible for only about 1,000 state member banks. Federal Reserve examination of bank holding companies and their bank affiliates are not restricted to member banks and consequently are not affected by the loss of member banks.

4) It is questionable whether monetary policy is made more difficult by the loss of members. The primary tool of monetary policy is open market operations and, as long as all banks hold some cash reserves, this tool is not affected by whether a bank is a member or not. There is no empirical evidence of which I am aware that high, or for that matter, any reserve requirements are necessary for monetary policy. True, the deposit multiplier would be greater the lower the average reserves required, but the question is not the magnitude of the multiplier but its stability. Indeed, a major cause of the instability in the multiplier in recent years has been the Federal Reserve's own policy of proliferating different reserve requirements against different types of deposits and different sized banks. As I have noted in an article some time ago in the Financial Analysts Journal, this proliferation of reserve requirements has made monetary control more difficult for the Federal Reserve. ("Federal Reserve Inability to Control the Money Supply: A Self-Fulfilling Prophecy," September, 1972). Maintaining or even increasing membership with the present structure of reserve requirements would do little to encourage efficient monetary control. Simplification of the reserve requirement structure would be desirable. Moreover, as long as the Federal Reserve uses a Fed funds target in the implementation of monetary policy, the stability of the multiplier is not important and the question of monetary control being affected by loss of member banks becomes mute.

Collection of necessary data for monetary control is not a function of membership but of appropriate legislative authority. The FDIC is already legally able to collect sufficient data on deposits at nonmember banks to offset any information lost by banks withdrawing.

5) This is a real problem and in many ways the crucial one. Why be a member bank if the cost of being so outweighs the benefits? All the proposed solutions are designed to deal with this inequity and to try to reduce the burden to member banks relative to nonmember banks.

6) Federal Reserve independence is affected by the decline of membership if the remaining members become, as is a possibility, a small group of homogenous banks, such as a small group of the very large banks. In this situation, the Fed may be viewed as a spokesman for that group. This is not a good positin for an "independent" agency.

7) Federal Reserve international prestige is viewed primarily by its success in conducting monetary policy, not in the number of its member banks. Central banks in other countries do not have member and nonmember banks and I have not seen any reference to the prestige of the Bank of England or the Bundesbank in terms of their relationships with their banks rather than their ability to achieve the goals of monetary policy.

8) The fewer the number of member banks, the smaller the Fed's balance sheet, the smaller Fed holdings of Treasury securities the lower Fed income, and the smaller Fed income transfers to the U.S. Treasury. Although possibly large in absolute dollar magnitude, the net revenue loss to the Treasury must be judged relative to the gains or losses in both revenues and economic welfare from any program adopted to stem the membership loss. This is difficult to determine until a membership plan is specified in detail.

9) It is likely that the continued loss of member banks is a major source of embarrassment to the Federal Reserve System. This would be similar to any voluntary organization, such as a country club, which views itself as prestigious and would lose this prestige if its members would continue to drift away. Either the prestige or the voluntariness of the organization must go.

My summing of the above arguments suggests that the membership problem is far less serious than suggested by the Federal Reserve. The only two real aspects of the problem are equity and embarrassment and, if any proposal is adopted, it should be for these reasons. Embarrassment, of course, may be eliminated entirely by having all commercial banks members. This was the intent of Congress in the Banking Acts of 1933 and 1935 when it required all insured banks to become members of the Federal Reserve System. Ironically, this was opposed by the Federal Reserve and was finally dropped from the FDIC legislation in 1938. Much the same result may be obtained by subjecting all banks and possibly other competing depository institutions to universal reserve requirements without formal membership as proposed by the Fed.

An alternative to requiring all banks to be members would be to have no members at all. This is a radical but interesting solution that may be worthy of at least some consideration. It is not as wild as it might appear at first. All of the above problems would be solved, except loss of revenue to the Treasury and, possibly, monetary control, by not having member banks and having state reserve requirements apply to each bank. Revenue losses would accrue to the Federal government budget as substantially fewer reserves would be held at the Federal Reserve banks. But, in order to maintain the current money supply and to offset the higher deposit multiplier, the Federal Reserve would need to absorb reserves by selling securities and the Treasury would recoup some of the lost income through taxes on the interest earnings of the banks. Most economists believe that membership is not needed for monetary control. The discount window can be made accessible to all institutions. Data could be collected from all commercial banks. The Federal Reserve would still have regulatory responsibility for bank holding companies and their bank affiliates. The domestic and international prestige of the Federal Reserve System would not be dependent on its number of member banks, but only on its ability to achieve the goals of economic policy. The Federal Reserve could charge a market rate for all services that it provides or could drop many of these services and let the private sector provide them. All banks would be eligible for the many services that the Federal Reserve provides. This solution would reduce the current inequity among member and nonmember banks and would eliminate the embarrassment problem.

Although removing all membership is a radical solution, it is the easiest and most straightforward. All other solutions become messier. The Federal Reserve and other proposals focus primarily on compensating member banks for the burden of membership by paying interest on reserves and offsetting the higher income to the banks by charging for services now provided free of charge. The two issues are really separate. The first, payment of interest on reserves, attracts members; the second, charging for services not provided free, discourages members. By itself, unbundling and charging for services is justified on the basis of increasing the efficiency of the payments system. But, because under both proposals the fees collected by the Fed would be used to redistribute to banks in any way that the Fed sees fit, these charges take on implications for membership.

As long as reserve requirements for member banks are much greater than for nonmember banks, payment of interest on reserves is necessary to reduce the burden of membership. However, the very cause can be removed by reducing reserve requirements. The requirements on member banks could still be somewhat greater than for nonmember banks if the Federal Reserve were to provide services free as they do now, but the requirement would have to be more or less the same as for nonmember banks if the Federal Reserve were to charge a market rate for its services. In many ways, reductions in reserve requirements would be an easier and more straightforward solution than paying interest on required reserves. Such action would, of course, require legislative action. The impact on Federal revenues may not be expected to be greatly different than for payment of interest.

The primary disadvantage of interest payments on reserves, other than the impact on the budget, which would be small under most conditions if increased membership really solved the "problems" noted earlier, is the problem of what rate should be paid and whether to pay all banks equally. Tying the interest rate to the return on the Fed's portfolio is appropriate, but restrictions on the maximum amount be paid according to bank size and inverse graduation makes little economic as opposed to political sense. By changing the rate that is paid on reserves, the Federal Reserve can have major impact on membership and can achieve any membership proportion that it wishes. By raising its rates slightly, it can make membership so attractive that all banks would become members. By paying an insufficient return on reserves, the Fed would not completely compensate for the period of membership. The same is true to a lesser degree for the charges it sets for its services.

Let me now turn more specifically to the proposals. The Stanton Bill (HR 12706) as amended by you has many good features but also possesses some limitations:

1) Limiting the interest that may be paid on reserves to the value of the services rendered plus revenue from the discount window may be insufficient to offset the membership burden. If so, nothing is achieved except to redistribute bank earnings. Alternatively, the Fed may be tempted to play with the service fees to offset any shortfalls in interest income necessary to offset the costs of membership.

2) Although I agree that changes in the reserve requirements are not necessary for monetary control, they may be useful at times to supplement other tools. Having to go to Congress to have reserve requirements changed is inefficient. A possibility might be to narrow the range somewhat more than is currently permissible.

3) Tying the discount rate to the Treasury bill rate is in general a good idea, but unfortunately is not a good idea under lagged reserve requirements. As I have noted in earlier correspondence to you, lagged reserves effectively shift the cutting edge of monetary policy from open market operations to the discount rate. Because the Fed has to provide all the reserves that the banks need to meet their required reserves, which are determined by their deposit two weeks earlier, the Fed can control deposits or money supply only by changing the cost of marginal reserves provided through the discount window relative to the market rate. The higher the cost, the slower will banks expand deposits. Conversely, the lower the cost of borrowed reserves, the faster will banks expand deposits. If the discount rate and the market rate were tied together so that the difference would never change, the Fed would have no way of influencing bank deposit expansion and would lose its control over the money supply. Because, as you have argued in the past, lagged reserves have complicated the Fed's ability to control the money supply, this may be a good time to remove this scheme once and for all.

The Fed's proposal for universal reserve requirements has considerable theoretical appeal but I would guess little political appeal in the near term. Thus, I shall not discuss it in this letter. If HR 13476 is not enacted, the Fed proposes to pay interest on member bank reserves subject to the limitations of HR 13477, restructure reserve requirements for member banks, and charge for services. This bill has one advantage and two disadvantages relative to HR 12706.

Its major advantage is that more funds would be available to be used to pay interest on reserves, if necessary, to offset the burden of membership completely. The limit on these payments to banks according to bank size again has little economic appeal. The higher costs to the Treasury should be judged on the basis of the cost effectiveness of the program.

The major disadvantages are:

1) the failure to have Congress explicitly authorize interest payments on reserves,

2) less specific guidelines for pricing services, and

3) failure to include additional authority for reporting of data on deposits.

Because the pricing of services is difficult for any government agency, it is important that the guidelines be as explicit as possible so that pricing does not become a policy issue and used for objectives other than increasing market efficiency. Insufficient deposit data is one of the real costs of fewer member banks. Although these data can now be collected for the Fed by the FDIC and other regulatory agencies, it would be preferable to formally authorize this additional power to the Fed as in HR 12706.

Between the two proposals, I favor HR 12706 as amended over HR 13477. But I have serious doubts whether the "cure" contained in either bill is necessary or better than the "disease." Because the membership problem does not appear to be sufficiently serious to require immediate emergency action that would introduce major structural change in our monetary system, I would recommend that Congress not act in undue haste. These bills should be evaluated slowly and carefully so that any changes introduced are both necessary and superior to the existing structure.

If I can be of further assistance, please let me know.

Sincerely,

George Kaufman

George G. Kaufman

Columbia University in the City of New York | New York, N.Y. 10027

DEPARTMENT OF ECONOMICS International Affairs Building

July 26, 1978

Mr. Henry S. Reuss
Chairman, Committee on Banking, Finance and Urban Affairs
2129 Rayburn House Office Building
Washington D.C. 20515

Dear Mr. Reuss:

In response to your letter of July 17, 1978, I hereby submit the following comments on proposals concerning reserve requirements and interest on reserves.

I strongly endorse the purposes of the bills which your Committee will be considering as outlined by you on the floor of the House on July 14th. We are rapidly losing control over the money supply with grave consequences for monetary stabilization and runaway inflation, and these proposals help to reassert monetary control. It is vitally important to institute reserve requirements on all transactions balances, as all the proposals and particularly HR 12706 provide. Aggregate national spending is controlled by the quantity of such transactions balances. Such balances should be controlled no matter where they reside in the financial system.

No one can be sure how high the reserve requirements should be for satisfactory control. The ratio of the monetary base (deposits with Federal Reserve Banks and vault cash) to the money supply should be high for better control, but not so high as to be unacceptable to depository institutions. It is a question of balancing public and private interests. The requirements proposed in HR 12706 are probably a reasonable compromise. I agree that, once set, there is no need to change them for purposes of short-run monetary policy. I would, however, require that such reserves be held in the form of the "monetary base" as deposits with Federal Reserve Banks or vault cash. Holdings in the form of Treasury securities should not be contemplated (such holdings would simply monetize the bills outstanding, to no purpose), and reserves allowed to be held in the form of balances with member banks should be sharply limited in extent and percentage of total requirements, if not disallowed altogether.

I might add some additional judgments on the proposals for your further consideration.

1) The definition of "transactions balances" might be extended to include all financial institutions, including so-called "money market funds," which provide for availability of funds faster than the normal period for selling bonds and stocks, usually three business days. The purpose of this inclusion would be to discourage the growth of close substitutes for transactions balances which remained uncontrolled. This prevention would stabilize the volume of assets with which aggregate spending is conducted.

2) Up-to-the-minute information on the magnitude of the monetary aggregates, particularly transactions balances, is becoming more and more imperative. Provision in these bills for the collection of data from all depository institutions providing such balances is commendable. It is a mistake, however, not to allow one institution, the Federal Reserve, to receive this information directly. Interposing the other agencies, FDIC, FHLBB, etc., will slow the collection time unavoidably and even limit the extent and quality of the data. There will be little loss in not succumbing to agency rivalries of no importance to the public interest and much gain, if the Fed is allowed, under suitable limitations, to prescribe and receive this information directly. With the advent of electronic banking methods, the possibility of greatly improving the availability of up-to-date data should not be unnecessarily impeded.

3) I endorse tying the discount rate to movements in Treasury bill rates. The Fed should be allowed, however, some discretion in setting or from time to time in changing the amount of the fixed differential, positive or negative, between the discount rate and the Treasury bill rate, and specifying how long the lag of changes in the discount rate in response to changes in the bill rate should be.

4) It would be most desirable to abolish lagged reserve requirements, but that is a technical issue that probably should not be legislated. It is possible, however, to instruct the Fed that reserve requirements should be imposed on reported transactions balances as recently in time as is feasible, for purposes of tightening the relationship between the monetary base and the quantity of transactions balances.

5) The provisions of this legislation should go into effect no later than the Fed's standing proposal to allow, beginning November 1st, automatic transfers from savings deposits into demand accounts. That proposal creates a close substitute for demand balances with little control over the volume outstanding and will be disruptive of monetary stabilization. The present bills, which would impose equal reserve requirements on all transactions balances, saves the day. The Fed's November 1st proposal should be delayed until this legislation is put into effect.

6) I heartily endorse the payment of interest on reserves. I would strongly urge you to reconsider your position that the amount of interest should be severely restricted after a short transition period. Most of it will go to the public as interest on deposits or services; hence to view it as a "drain" on the Treasury is too narrow a view. Interest payments should not be restricted below a reasonable percentage return because the holding of idle reserves is a cost to the monetary system and the public which economic studies have shown is completely unjustified and undesirable. Moreover, it is essential that depository institutions not face a strong incentive to avoid reserve requirements. Such incentives to avoid reserve requirements are partly responsible up to now for the evolution of financial practices which are creating severe problems for monetary control. The Committee should also contemplate removing the prohibition on payment of interest on demand deposits directly, since new arrangements are doing so indirectly anyway.

7) Charging financial institutions for services received from the Federal Reserve is desirable. However, the Fed should be given some leeway in pricing the services during the start-up of new systems, so as not to price themselves out of the market. There should, of course, be no "below cost pricing" in the long run which would prevent the introduction and growth of private clearing systems, so long as they did not interfere with monetary control.

Monetary control is the most important consideration in all of this. Inflation is our Number One problem, and we must have the means to control the growth of monetary assets.

Finally, let me express my approval for the equal treatment in these bills of <u>all</u> institutions which offer "transactions balances" broadly defined. It is vitally important that all such balances and the institutions providing them be treated equally with respect to reserve requirements and reporting, so that we do not create differential incentives producing differential behavior. I urge the Committee to deflect any pressures to exclude or give special treatment to any special class of institutions, whether credit unions or any other.

Sincerely Yours,

Phillip Cagan

Phillip Cagan
Professor of
Economics

Written comment [which I hope can be followed up by oral testimony at Committee hearings] on HR 12706 and other legislative matters before the COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS, U.S. House of Representatives, from

Albert Gailord HART

Professor Emeritus of Economics
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27 July 1978

Federal Reserve membership and universal reserve requirements

The issues linked with "membership" of banks in the Federal Reserve System offer the best point of entry into this set of legislative issues-- both because of the approach of HR 12706 [entitled the "Federal Reserve Membership Act of 1978"] and because these issues seem to be the key logs in the monetary-policy log-jam. A good settlement of the membership problem will place the Congress in a position to take hold of a number of other issues that now seem refractory.

The organization of the Federal Reserve System as a voluntary association of commercial banks is an oddity. The system exists, of course, because of the public interest in having orderly and appropriately-paced growth in the stock of money and in related forms of credit. Banking is of public concern because the deposits created by extension of bank credit are the major part of the stock of money. To run a deposit-creating bank is sometimes spoken of as running a private mint-- an activity which surely needs some kind of public supervision. Yet what brings a bank under the control and supervision of the Federal Reserve is not the fact that banking is a monetary operation: non-member banks are active, and recently non-bank institutions have been allowed to operate much like banks. Rather, a bank is under controls only if it volunteers to be a Federal Reserve member-- taking the stance that the advantages of membership (including perhaps a sense of public duty) outweigh some very perceptible burdens of membership.

The Federal Reserve authorities have long been uneasy over a tendency for banks to drift out of the system; and observers of Federal Reserve policy suspect that exaggerated fears of membership-loss may explain a certain tendency of the Federal Reserve to back away from some major policy issues. It says in the good book, "The wicked flee when no man pursueth." But the wicked are not the only ones who flee. Much of the damage from policy errors results from well-intentioned but timid people saying "Let's retreat to a more defensible position"-- and then finding that the position they abandoned would have been more defensible than the position they retreated into.

Both the legislative proposals introduced by Mr. Reuss at the request of the Federal Reserve (and presented as alternatives) relate to the membership problem. The first proposal is to remove the temptation for banks to shed the burdens of membership, by extending mandatory universal reserve requirements to all depositary institutions. The second proposal is to reduce the burdens of membership by paying interest on reserve balances held by member banks at Federal Reserve Banks. The second proposal (taking account of the fact that the maximum allowable interest rate is 2% when market rates are four or five times as high) would make so little difference to the net burdens of membership that the membership-attrition problem would scarcely be affected.

If the present voluntary-membership is untenable, a solution along the lines of the universal-reserve-requirements proposal is the logical remedy. The specific form of the proposal offered in the first Federal Reserve alternative, however, can be enormously improved. I offer suggestions to this end in the latter part of this memorandum.

Given a solution along universal-reserve-requirements lines for the membership problem, the question of interest on reserve balances (raised in the second Federal Reserve proposal and in the Stanton Bill) can be dealt with on its inherent merits rather than as a gadget to influence membership. Either the traditional zero-interest treatment of reserve balances or a new system with interest paid on such balances would be workable under universal reserve requirements; the question is which will be more useful.

Interest on reserve balances

The traditional zero-interest treatment of reserve balances creates what is referred to as a "burden" on members-- consisting of a loss of potential interest because the member bank is not free to put all its resources into earning assets as can a non-member institution. This loss of potential interest may be seen as some sort of undefined mixture of a charge for services which the Federal Reserve performs gratuitously for member banks, plus a "franchise tax", related rather vaguely to the scale on which a bank operates as a "private mint".

Economists are bound to find appealing the logic of the Stanton Bill, which stresses the appropriateness of a charge for Federal Reserve services (check-clearing and the like) appropriately related to service-costs. Making such services available at a fee to non-member institutions also makes sense.

On the other hand, such a rational system of service-charges is incompatible with the voluntary-membership system unless interest is also paid on reserve balances, since incentives to leave the Federal Reserve are intensified if member banks are deprived of the main advantage of membership without any reduction of its burdens. Hence the logic of the Stanton Bill extends (in its Section 3) to the authorization of such interest.

At present and for the visible future, we must recognize thatthere is a wide gap between the cost of Federal Reserve services and what the sums tied up in required reserves would earn at full market rates. This difference shows up in the earnings of Federal Reserve Banks, the great bulk of which are siphoned into the Treasury. Chairman Reuss is correct in regarding this arrangement as equivalent to a tax on the activities which give rise to reserve-needs. In principle, it must be possible to replace such a tax with some other better-designed tax, or if tax-reduction is in process, to drop it rather than make some other tax-cut. My impression is that on the whole we will get more public benefit from the tax-cut process that goes on from year to year by reductions in other taxes than by reductions in this tax, and that the case for allowing interest on reserve balances to exceed service charges is not a strong one, once subjection to reserve requirements ceases to be voluntary. Given a solution of the membership problem along universal-reserve-requirement lines, the interest-on-reserves problem thus turns into a problem of taxation, and should be treated as such rather than as a monetary problem.

One special aspect of the interest-on-reserves issue, however, seems to have escaped attention, and is immediately relevant to the legislative problems before the Committee. Behind the scenes, but in actuality very much a part of these legislative problems, is the Federal Reserve proposal to amend Regulation Q so as to authorize "automatic transfer" of customer funds from savings to demand accounts. If this proposal goes into effect, large sums now held in regular demand-deposit accounts (mostly subject to a reserve requirement of 16 1/4%) will be transferred into the new checking/savings accounts and be treated as savings deposits. If the present 3% requirement on savings deposits is maintained, each million dollars transferred from demand to savings deposits releases ($162,500-$30,000=$132,500). If the Federal Reserve sets up a special "savings" category with a higher reserve ratio, the release will be smaller. At a 10% reserve ratio for this category, the release would be ($162,500-$100,000=$62,500)-- smaller but still substantial. Furthermore, the Federal Reserve might feel it best to reduce the gap between the two reserve requirement by lowering the requirement of 16 1/4% on demand deposits at banks with over $400 million of deposits, which would increase the amount released. Since it would scarcely be prudent to accelerate credit expansion by letting the released funds become excess reserves, the Federal Reserve would have to absorb them by selling government securities on the open market-- reducing substantially its portfolio and the earnings transferrable to the Treasury.

Previous Federal Reserve policies have already abated the "tax" in question in a capricious and undesirable way. I refer to the Federal Reserve toleration of the socalled "repurchase agreements", which have the effect of putting tens of billions of immediately-available corporate funds into interest-bearing form and taking these funds outside the total of demand deposits on which reserve requirements are based. This toleration of repurchase agreements thus amounts to handing over a good slice of the "tax" on reserve balances to a favored group of customers (those who can move funds around in lumps of $5 million or more!), and enabling these customers to earn interest on demand funds as ordinary mortals cannot. Is this tax equity?

Interest on checking accounts

Since the monetary reforms of the 1930's, commercial banks in USA have been legally prohibited from paying interest on demand deposits. The purpose of the prohibition was specifically to make banking more profitable, with the hope that earnings would be used to replenish depleted bank capital and reduce the risks of the Federal Deposit Insurance Corporation. The ability to attract checking deposits without paying interest upon them thus became a valuable privilege for commercial bankers-- one of the privileges for which a "franchise tax" (in the form of loss of potential interest on reserve balances) could be deemed appropriate.

Zero interest on checking deposits is scarcely part of the order of nature. US banks had paid such interest for more than a century before the 1930's, and banks in most other countries pay interest on checking balances today. With the substantial rates paid on assets which do earn interest, bank customers would of course welcome such payments; and the "cash managers" of corporations and municipalities have sought ways to limit their holdings of zero-interest demand deposits, and to make time deposits, other liquid assets, and lines of credit serve purposes traditionally served by checking balances. In order to attract customers, banks and other financial institutions have introduced a series of financial innovations, enabling customers either to put into interest-bearing assets part of what would previously have been held as demand deposits, or else to handle transactions with a reduced holding of cash. Such devices as negotiable certificates of deposit or interest-bearing balances with bank branches overseas (or purportedly overseas: some such branches actually operate in New York and other US financial centers) permit holding quickly-available funds in interest-bearing form. Other arrangements enable customers to draw checks against non-existent balances by use of overdraft and other line-of-credit arrangements. The Federal Reserve has been permissive toward these innovations, which have enabled corporations and municipalities to bypass the ban on demand-deposit interest, collecting interest on a good share of cash resources without impairment of liquidity.

Demand-deposit interest by subterfuge?

The legislative proposals brought before the Congress by the Federal Reserve in July 1978 are silent about interest payments by banks on their customers' checking balances. Nevertheless, the Federal Reserve is moving effectively to nullify the legal ban on such interest payments, by the route of an amendment to Regulation Q. In the guise of an authorization for banks to arrange "automatic transfers" from their customers' "savings" balances to their checking balances, this amendment permits placing funds in checking/savings accounts, the greater part of which will be classified for purposes of interest-payment and reserve requirements as "savings", while the whole will be available to meet the customers' checks as they come in for payment.

While details of procedure remain to be worked out, the key feature of automatic transfer will be an agreement that the arrival of any check which would otherwise constitute an overdraft (or would pull the customer's balance below an agreed minimum) will be treated as constituting an instruction to the bank to transfer funds from the customer's savings account. The customer can then deposit all his incoming funds as "savings", and draw interest upon them till they are actually used. This is in substance the same thing as to draw interest on a demand deposit. The difference is merely a wrinkle in the bank's computer programming. The computer must be set so that it will divide the customer's deposit balance into two components, book fictitious left-hand-to-right-hand transfers from one component to the other, and calculate interest on the component called "savings". This system could be operated with a zero-interest "demand deposit" component of zero dollars, by transferring just enough to meet each check as it comes in for payment. Demand balances will exist in such checking/savings accounts only insofar as transfers are made in larger lumps to reduce the number of items the computer must handle, and as banks induce customers to maintain some modest minimum of demand balance in consideration of avoiding service charges on checks drawn.

The establishment of automatic transfer has been presented to the public as a mere technical change in the interests of convenience and operating efficiency. [The only public interest, over and above convenience to individual customers, cited by the Federal Reserve to justify the change is "a saving that benefits the public at large through lower operational costs of the Federal Reserve System due to a reduction in the number of checks written on accounts with insufficient funds"!] But in fact the change is a major alteration in the socalled "monetary constitution" of the United States.

The underlying question is whether it is important to maintain a <u>difference of kind</u> between money and non-money assets, and if so whether zero-interest on money ("checkbook money" as well as "pocketbook money") is a useful element in that difference. This question-- related to that of the "open-ended money supply" to which I come in a few minutes-- is very much the business of the Congress. No showing has been made that the public will be injured if the automatic-transfer system is introduced (say) at the end of 1979 rather than in November 1978. But a hasty move in this direction may prove to be an irreversible decision to make almost indistinguishable the difference between money and other assets, and to accept a major handicap for future monetary policy.

Although it is not mentioned in the legislative proposals before the Committee, the Federal Reserve's automatic-transfer proposal amounts to a major change in the law. And there it sits as a legislative time-bomb-- out of sight and perhaps out of mind, but cheerfully ticking away behind the scenes. Unless it is defused either by congressional action or by some court decision in response to the suit brought by the U.S. Savings and Loan League, we will find a few weeks hence that an important part of the legislative framework of US monetary policy has been effectively repealed, without bringing to bear informed congressional or public opinion.

The Federal Reserve's proposals for dealing with the consequent situation as regards bank reserves are extraordinarily confused. If the Congress adopted the second Federal Reserve alternative, authorizing interest on reserve balances, the reserve-requirement framework would be the same as it is today, with options for the Federal Reserve as to reserves on checking/savings deposits covering a range from 3% to 10% (the time-deposit limits). If the Congress adopted the first Federal Reserve alternative, the definition of the new term "transactions accounts" [" a deposit or account on which the depositor or account holder is allowed to make withdrawals by negotiable or transferrable instrument or other similar item for the purpose of making payments to third parties or others"] would seem to include checking/savings balances. On the other hand, the items specified as included in "transactions accounts" are only demand deposits and NOW accounts. For demand deposits a reserve ratio of 7% to 22% is proposed; for other transactions account 3% to 12%; for time and savings deposits (which is where checking/savings would fit under the Board's May announcemant) 0.5% to 10%. While the Federal Reserve would be authorized to rule as to whether a stated type of account was or was not a transactions account, a bank would have many options as to the contractual forms it used, and might have a good deal of freedom to move balances from one reserve category to another.

Even with a definite ruling from the Federal Reserve as to which reserve-category applied and what the applicable reserve-percentage was, the reserve position would be riddled with uncertainties. The scale on which balances would be transferred into checking/savings would depend on the contracts offered by the banks and their acceptability to the public. A substantial and perhaps enormous release of required reserves would be set off by this shift and Federal Reserve efforts to offset the effect by open-market operations would have uncertain impact because of the possibility that banks could alter the pace of the shift by advertising new and ingenious contract-wrinkles to attract customers' attention. (The likelihood that this will be a major focus of customer relations is signalled by the fact that some important commercial banks are already inviting customers to sign automatic-transfer agreements to go into force on November 1). Both banks and their customers would have to work out by experience the way to operate under the new system; and no doubt banks would offer (successively or simultaneously) a number of different systems of transfer, with varying transfer-fees, minimum-balance understandings, etc., and perhaps with varying interest rates. Thrift institutions would also have to relate themselves to the system. Furthermore, there would be pressure either to extend the automatic-transfer system to additional groups of depositors (beyond the "individuals" to whom it is addressed in the first instance) or else to develop various other arrangements that have somewhat similar effects. If the Federal Reserve set a 10% reserve requirement on checking/savings balances, for example, but lower requirements on other classes of time deposits, banks would be interested in devices for quasi-automatic transfers out of deposits that are otherwise classified.

It is not unlikely that a bank which found itself under reserve pressure could manage either to reduce its deposits subject to the higher reserve-deposit ratios or to attract new funds from outside by unveiling a new offer for the handling of checking/savings account. Besides, a bank engaged in a process that would release required reserves presently would probably be much more ready to borrow from the Federal Reserve rather than restrict credit if it came under reserve pressure. I infer that the reaction of banks to open-market operations which reduce or enlarge the pool of "unborrowed reserves" would be uncertain, and that for some years the reaction-pattern would be in a process of unpredictable change.

The public's "demand for cash balances", which is the centerpiece of much of the work economists do toward understanding the monetary situation, would also be in a state of flux. The tendency of automatic transfer to reduce the difference of kind between money and non-money assets probably conduces not only to the holding of a large share of total "money" in checking/savings deposits, but also to a reduction of the total. The whole situation would be different from that experienced in previous years in a way which would greatly reduce the comparibility of past experience with the current situation, and the reliability of econometric estimates of the way the current situation will be affected by policy changes or external events.

These factors of uncertainty, of course, are not entirely to be attributed to automatic transfer. We stand on a slippery slope; and any policy (including one of legislative inaction with the automatic-transfer arrangement dropped) still means that we will be in a new situation with which past experience is not highly comparable. But the automatic-transfer proposal is sufficiently important to shake the situation up, and to intensify the speed of change in a number of other processes that affect the monetary situation.

Open-ending of the money supply

Everybody who watches monetary affairs is aware that the measurement of effective money supply has become very baffling. M1-- the total of hand-to-hand currency plus checking deposits-- clearly does not any longer even approximate the money supply. There is too large a fund of other "transactions accounts" to keep track of. On the other hand, none of the array of alternative money-stock members (M2, M3, M4, M5) is really more satisfactory. Some of the items outside M1 which they include (notably the NOW accounts which enter M3) are much the same as M1. Other items are quite different-- representing for example long-term savings held to buy a house, pay for college education, or help toward retirement. If a meaningful total can be compiled, it will include M1 plus selected elements from the more inclusive totals. Allowance must be made also for the fact that monetary functions are performed by what may be called "invisible money", not included in any of the aggregates.

A list of some of the main forms of effective means of payment not included in M1 will be illuminating:

a) More and more, individuals are able to draw checks beyond what their demand-deposit balances will cover, under arrangements that go by such names as "privilege checking". In principle, the long-standing rule against overdrafts in US banking has not been abandoned. But this principle is bypassed (without objection from the Federal Reserve) by agreeing that a check which otherwise would constitute an overdraft will be treated as a loan application-- which will automatically be granted. No statistics are published on these "privilege" arrangements; but they must be equivalent to several tens of billions of demand deposits.

b) Similarly, unused corporate lines of credit are available to cover checks; the drawer of uncovered checks may be obligated to notify the bank, but need not seek its permission. While such arrangements have existed for decades, they seem to be of rising importance.

c) NOW accounts at thrift institutions (and likewise on the savings-deposit side of many commercial banks) represent a breach with the tradition that checking facilities go only with commercial banking. Experience in New England (where NOW accounts also bear interest) suggests an enormous potential scale-- in New England, about one account per family, though average balances are modest. They represent a focus of competitive forces that generate effective money outside the traditional M1.

d) An arrangement somewhat misleadingly called a "repurchase agreement" enables large corporations to hold much of their most liquid funds in interest-bearing form not subject to reserve requirements. Any depositor who can deal in lumps from $5 million upward can arrange that as of the close of business, funds left over from covering checks cleared that day can be placed in an interest-bearing loan to a bank, secured by part of the bank's security-portfolio, to be repaid next day or in a few days. These funds can be fully available to cover checks drawn the day the arrangement is made, which will come in for payment next day or shortly after. Yet for calculation of the bank's reserve requirements, these funds are treated as non-existent; and they earn an interest rate close to that on federal funds. Once again the Federal Reserve does not choose to object, although the arrangement is a transparent evasion of the reserve-requirement rules and of the law against paying interest on demand deposits. Tens of billions are outstanding.

e) Other kinds of overnight and short-term funds have become much more available to cash managers for corporations and municipalities. Eurodollars, though apparently they are not commonly handled as checking balances, present their owners each day with a large runoff, available to cover checks which come in for payment or (at a still higher level of disposability) available for Telex transfer anywhere in the world. The Federal Funds market, which started out as an offsetting of transitory excess reserves against transitory reserve deficiencies among member banks, has somehow evolved into a gigantic overnight-funds market where non-bahkers are very active. Negotiable certificates of deposit and commercial paper (much of it issued by banks) also offer very liquid forms of holdings. Cash management funds offer to place a corporation's excess funds in short-term assets and make them available on a same-day basis for Telex transfer. All these developments together represent liquid-asset availability on a scale of hundreds of bilions, completely dwarfing the $10 billion or so in the traditional form of brokers' loans.

It will be noted that the effective stock of means of payment outside M1 consists largely of items which are "invisible", having no place in the statistics of M1-M2-M3-M4-M5. This whole evolution tends to rub off the edges of the distinction between what is and what is not money.

Compounding this process is the evolution of a sense on the part of a large proportion of potential borrowers (both firms and households) that credit is available semi-automatically. ["Yes is a CHEMICAL reaction," says one appealing advertizing slogan.] Corporations expect to be able to borrow at their regular banks, arrange for a big loan with a consortium of banks, or float commercial paper on a few days' notice--for expansion of inventories and receivables, for interim financing of capital expenditures and acquisitions, or merely to roll over previous debts. Rueful parents facing college bills are partly consoled by the assurance they can readily renegotiate their mortgages for a larger sum. People whose jobs shift location can be confident that the people who take over their houses can be financed to pay a handsome price, and that they themselves can readily get credit to buy a house at the new location.

It is still important, of course, to have an equity in order to be able to borrow on mortgage. But people seem to be falling into the habit of counting on inflation in the value of the old house to provide equity for the new. Hence availability of credit reduces the incentive to accumulate money and other liquid assets. True, availability of credit is "at a price"; but inflationary experience tells would-be borrowers that the interest rate falls short of compensating for inflationary erosion of the real value of the principal, so that the "price" (seen as "real" interest) is apt to be low or even negative.

Difficulties of monetary policy with open-ended money

The traditional view of monetary policy has hinged upon the impact of rapid or slow growth of the money stock upon price levels and economic activity. If the economy overheats in any country, we expect the IMF to recommend and the local authorities to apply a policy of braking monetary expansion; while if an economy runs slack, faster monetary expansion can encourage more production and employment. An influential school of opinion holds that while accelerating and braking monetary growth may do more harm than good to economic stability, growth with stability could be had by a policy that generated a moderate steady rate of monetary expansion.

Guidelines for monetary policy have been discussed largely in terms of setting suitable targets for the expansion of M1. It will be evident at once that when a large part of the growth in effective money takes place in items excluded from M1 (many of them invisible), what happens to M1 may not be very indicative of the monetary forces at work on the economy. In the present situation, if the automatic-transfer arrangement is allowed to go into force and proves highly popular with bankers and the public, the equivalent of last year's 7.7% expansion in M1 might well turn out in 1979 to be an "expansion" of minus 5%! There will be no way to determine in advance what rate of growth in M1 will represent what intensity of expansive pressure. If the automatic-transfer arrangement is not put in force, there is less room for a sudden massive transfer from demand deposits into forms not included in M1. Nevertheless, a number of minor new financial innovations may well be beginning to take hold in 1979, while the effects of a number of past innovations must still have a long way to go. The fact that the rise of velocity has been so nearly constant over a number of years (with many instances where velocity rose from year to year despite drops in interest rates, in the pace of inflation, or both) points strongly to the presumption that the effects of each innovation are spread over considerable time. And the acceleration of velocity in the last few years suggests that the backlog of partly-unrealized effects of past changes remains considerable.

Stating targets in terms of broader aggregates (M2 or perhaps M3) does not get us away from the difficulty. A large proportion of the commercial-bank time deposits which enter M2 and of the thrift-institution accounts which enter M3 must be presumed to represent bona fide long-term savings accumulations, as I indicated above; the monetary effect of growth in these claims must be concentrated in a few spots.

There is of course a school of monetary analysts who take the view that the monetary influence on the economy is transmitted entirely by interest rates, and hence the way to conduct monetary policy is to strive to bring about an appropriate level and structure of interest rates. In its extreme form, this view would indicate that it does not matter that monetary-quantity targets are ambiguous-- that policy should be guided solely by rate-of-interest criteria, letting the money-quantum chips fall where they may.

In the present state of the world, it seems to me it would be very imprudent to guide US monetary policy solely by interest-rate criteria. It is a fact of life, of course, that the Federal Reserve's <u>tactics</u> (especially in open-market operations) impinge on the market. But an effective <u>strategy</u> toward interest rates is another matter. In the first place, the markets that determine interest rates are world-wide. It is true that with flexible exchange rates the interest structure may differ from country to country. But there is powerful arbitrage which tends to equalize the <u>combined</u> effect of interest rates and exchange-rate changes, working on forward markets which penetrate deeply the economic structure of all the industrial countries. An attempt to run an autonomous interest strategy, even in a country as large as the United States and with flexible exchanges, is likely to run into unacceptable foreign-exchange consequences. In the second place, the interest rate which is supposed to influence private investment, saving, and the pricing of assets that do not have fixed dollar prices is what economists call the "real rate"-- that is, the nominal rate corrected for the pace of inflation. Efforts to regulate the structure of nominal rates may be ineffective in relation to investment, saving and pricing-- or may even have perverse effects, pushing real rates into ranges which no policy-maker would recommend.

In these circumstances, any standard for monetary policy must work with targets for expansion of the stock of money-- either in addition to targets for interest rates (as in recent Federal Reserve formulations in response to demands from the Congress) or possibly even to the exclusion of interest-rate targets. The danger of an open-ended stock of effective money is thus considerable. It leaves us in doubt as to what sort of economic quantity is actually applying monetary pressure to the economy-- not merely what convenient statistical measure we can adopt. Another aspect of the problem is that targets should be set in terms of a variable that can actually be influenced by policy actions, rather than of a variable that is somehow free to go its own way. The variables that need to be steered to guide the economy include the forms of means-of-payment that do not enter M1 or even M3, while the long-term-savings component in M3 contains important elements that cannot and need not be steered. The flabbiness of measurement entailed in using M1 or M2 as a target variable is thus matched by a flabbiness of policy itself, since the omitted items are left outside the ambit of control and are so powerful that their changes can overshadow in importance the changes in M1.

Some suggestions as to reserve requirements

The problem of designing a really good and effective system of reserve requirements is far from easy, and I do not pretend to have it under con trol. But it is plain that the views stated above imply that the existing system is very unsatisfactory; and such views should be tested by considering what they imply about reserve requirements.

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It will be evident from the discussion above that my analysis calls for "universal reserve requirements" because otherwise the membership problem of the Federal Reserve remains intractable, and because many of the means of payment outside M1 are beyond the reach of controls applied only to member banks. On the other hand, I hold no brief for the specific structure put forward in the Federal Reserve's first-alternative proposal. In the first place, this structure is too non-specific. It proposes what Chairman Reuss very properly calls "meaninglessly wide percentage ranges", suggesting that we should simply tell the Federal Reserve to exercise its poetic imagination; and our experience with Federal Reserve discretion suggests that the resulting system would not reflect coherent policy insights. And in the second place, the structure does not take account of the tendency of banks to devise gadgets that will disguise highly active demand funds as assets outside the purview of the reserve-requirement system. I would agree with the stance of Chairman Reuss in favor of specifically-stated percentages for different categories of deposits and other accounts -- subject to legislative review if the Federal Reserve finds that experience necessitates changes-- and including many categories about which the Federal Reserve is silent.

As an academic game, it can be demonstrated that either high or low reserve-requirement percentages can serve the purpose of enabling the central bank to limit monetary expansion-- so long as the requirements are sensibly structured, and so long as member institutions do not carry highly variable amounts of either excess reserves or rediscounts. I would not claim to be able to prove that (say) a requirement of 16 1/4% on demand deposits at banks with over $400 million of deposits was better than a 20% requirement or than a 12% requirement. But I do assert that a requirement in the 10-20% range is better than a requirement of (say) 1% on the same type of deposits. The argument is two-fold: In the first place, reserves are affected by a number of events with large random elements-- notably by international movements of funds, shifts in the proportion of cash balances held in paper currency, variations in Treasury balances, and variations in the "float" of uncollected checks. If required reserves are set too low, these changes become large relative to required reserves, and can drastically change the relation between required and "unborrowed" reserves, with destabilizing consequences. In the second place, banks undoubtedly have two motives in holding reserves-- not merely to fulfil legal requirements, but also to meet short-term wobbles in over-the-counter currency withdrawals or in the balance of payments of the bank's body of customers in relation to the rest of the world. At present (taking account of the fact that reserve requirements apply to 14-day averages of reserve balances and deposits subject to reserve), the "voluntary" reserve-holding to meet the wobbles can be met by letting part of the required-reserve holdings do double duty. But if reserve requirements go very low, we may get into a position where "voluntary" reserve demand goes well above the requirements. Furthermore, the voluntary demand may well be rather unsteady in face of such events as sharp fluctuations in exchange rates or sharp breaks in the stock market. As with the first argument, we must conclude that setting reserve requirements too low will increase the destabilizing influence of factors that cannot be managed by the central bank. Particularly if policy shifts to admit of paying interest on reserve balances, prudence calls for keeping reserve requirements high enough to give assurance against these defects of very low requirements.

The main point I would make about requirements affecting what the new Federal Reserve semantics calls "transactions accounts" is that the concept should be broadly applied, and that reserve requirements on all such accounts should be in the same neighborhood (if not identical) with the percentages applying to demand deposits. The only item clearly included in "transactions balances" in the Federal Reserve's draft bill (over and above demand deposits) consists of NOW accounts. The rather ambiguous language seems designed to include also checking/savings deposits under automatic transfer if and when this arrangement goes into force. If this development can be headed off, as I would recommend, there will be no such item. But if it does go into force, I would urge that checking/savings deposits are the same thing as demand deposits, and should not benefit from a differentiated reserve-requirement percentage.

Over and above these items, my list of supplementary types of means of payment implies that banks should be called upon to report the unused balances of lines of credit (including those under "privilege checking" etc.) and be obligated to hold reserves against such unused balances. (I would not rule out the argument, however, that such balances are less likely to be used than actual demand deposits, having something of a contingent character, and perhaps a probability-coefficient should enter the reserve requirement.) Corporate and other funds converted into "repurchase agreements" should be regarded as merely demand deposits in slightly-disguised form, and should be subject to demand-deposit reserves, whatever may be decided about their eligibility to earn interest. I would assert also that "time" deposits payable within a week are effectively available almost at once, and should be subjected to demand-deposit rates. Deposits at overseas branches of US banks (at least unless their maturity is over a week, and perhaps one should insist on a longer maturity) should be subject to US reserve requirements -- unless perhaps in cases where equal or higher requirements are imposed upon them by the countries where they operate. I would urge also that there should be a presumption that banks and thrift institutions are incapable of having "non-reserve liabilities" (except for such obvious items as the bill for stationery not yet paid, and accrued pay of the help), and that bank-issued commercial paper and the like should be subjected either to the demand-requirement or the time-deposit requirement. A strong case could be made also that negotiable certificates of deposit (even though issued for periods up to several weeks) are so liquid from the standpoint of the holder that demand-deposit requirements should apply.

Turning to time deposits, there is much to be said in favor of the favorable discrimination (1% reserve requirement) which the Federal Reserve extends to time certificates of deposit running (from issue) for several years and with contractual provisions that really deter premature withdrawal. If there are universal reserve requirements, it may be feasible to induce thrift institutions to transform a fair proportion of their liabilities into such contracts.

The real problem on the time-deposit side is the claim typified by the old-fashioned savings-passbook account (or similarly-administered share-account at a savings and loan association, or credit-union account). In terms of the normal usage of the institutions, such funds are in practice available without notice; the fact that the customer cannot draw a check is offset by the fact that at many institutions he can arrange by telephone for transfer into a checking account. Yet it does not appear that such accounts turn over fast enough to justify the presumption that they are "really" demand deposits. Assuming demand-deposit requirements in the 10-20% range, a requirement in the 2-6% range now applied by the Federal Reserve to various types of time deposits seems sensible. But especially if the public begins to take a different attitude toward inflation, one can make a good case that such favorable reserve requirements could be justified only insofar as contracts governing such deposits really restrict their liquidity. The traditional "requirement of 30 days notice" on withdrawal has been used so rarely that it must be deemed meaningless by almost all depositors. I would suggest a rule that prior to withdrawal the funds must rest for 30 days in a non-interest-bearing transition-account, and that withdrawals directly out of the savings balance (rather than out of the matured part of the transition account) should incur retrospectively 90 days loss of interest. Such a rule would also correct the tendency to build up checking/savings arrangements, even in the absence of an official authorization for automatic transfer -- which may already be and certainly could sometime constitute a major leak in the system of reserve requirements for demand funds.

The case for a major monetary reform

There seems to be a historical law of monetary affairs, according to which control always applies to forms of money that were important in the previous generation, while financial innovation tends to bring in types of money that are outside the system of control. When the US constitution developed obstacles to state paper money ("bills of credit"), financiers developed bank notes. When state bank notes were done away with and notes of national banks restricted by the National Banking Act, financiers developed checking deposits. When checking accounts were brought more or less under control by the Federal Reserve Act and its major amendments of the 1930's, financiers developed highly liquid "time" deposits, negotiable certifiaates of deposit, Eurodollars, Nassau branches, NOW accounts, repurchase agreements, and contracts for transfers out of savings accounts. This process of innovation can scarcely have reached a terminus. If a new monetary reform brings under control the monetary processes just listed, we can be sure that new forms of money outside the list will be invented and expanded-- one can even make a few shrewd guesses as to next steps.

The gaps between major monetary reforms are often long. From 1789 (when the Consitution went into force) to the National Banking Act was 74 years-- though the Second Bank of the United States represented a good try at reform of the bank-note machinery, and various states took fairly effective measures. From the National Banking Act to the Federal Reserve Act was 50 years. We now stand 65 years from the Federal Reserve Act, and over 40 years from the significant interim measures adopted in the 1930's. Prior to each of the major reforms cited, the monetary setup of the country had developed a great deal of obsolescence; and considering the pace of financial innovation, it must be presumed that accumulated obsolescence is once more enormous.

In the absence of major reform legislation, of course, the situation is not altogether frozen. As private institutions and foreign monetary systems change their impact on the US economy, whoever is charged with the administration of policy will develop ways to cope, so far as can be done within the limits of the governmental structure and the administrator's policy conceptions. Thus before 1913, the Treasury found it unavoidable to take on some central banking functions, in order at least to correct the drastic consequences of accumulation or disbursement of Treasury balances at certain times of year. In the recent period, accomodation seems to have consisted largely of evolving a system of "special privileges for everybody", by adoption of a permissive Federal Reserve stance toward whatever changes in practices the commercial banks and other private agencies thought to be in their interest.

This year's legislative situation is astounding. The accumulation of obsolescence is scarcely perceived by the authorities as a policy problem; and when called on for proposals, the Federal Reserve mountain labors and brings forth a couple of stillborn mice. Its proposals are of very doubtful merit and efficacy. The second alternative (for a gesture toward paying interest on reserve balances) is totally inadequate in relation to the membership problem to which is is addressed. The first alternative for univeral reserve requirements is in principle capable of solving the membership problem in its narrow sense (risk of defections from the Federal Reserve System), but is so poorly structured and so riddled with omissions and inconsistencies that its adoption might well hamper rather than help a more adequate monetary reform. The Stanton Bill is very constructive on the matter of selling and pricing Federal Reserve services, but is of course not designed to cope with broader issues. The proposed amendments to the Stanton Bill are full of valuable ideas which will be of service if once general reform is undertaken, but are not presented in a way that could focus and rally public opinion as would be necessary really to clean up the situation.

In this memorandum, I have tried simultaneously to fulfil the Committee's request for comments on the pending legislative proposals and to cut enough deeper to show something of the character of the underlying monetary-reform problem. My guess is that when the Committee examines the numerous responses its request will bring in, it will find a similar depth of concern among many of those who respond. It would be a miracle if these responses converged upon a pattern which would give a basis for legislation in the next few months that will really handle the monetary problem. But the suggestions respondents will offer will probably show thelines along which a monetary reform could be developed.

For the immediate future, my chief recommendation is to keep options open-- and therefore to defer at least to the end of 1979 the automatic-transfer proposal, which threatens to make a total and perhaps inextricable mess of the relation between demand and time deposits. The Committee may find that the case for universal reserve requirements is strong enough to call for immediate action, with requirements broader and better designed than in the Federal Reserve's first-alternative proposal; though any system that could be cobbled together in the next few weeks would surely need more nature reconsideration before long. I would urge the Committee also to launch an effort (perhaps focused on a new Monetary Commission) to frame over the next year or two an adequate monetary reform, including both structural improvements and policy directives capable of making the Federal Reserve really face its responsibilities.

BROWN UNIVERSITY *Providence, Rhode Island • 02912*

July 20, 1978

The Honorable Henry S. Reuss
Chairman
U.S. House of Representatives
Committee on Banking, Finance
and Urban Affairs
Ninety-Fifth Congress
2129 Rayburn House Office Building
Washington, DC 20515

Dear Congressman Reuss:

I am writing in reply to your letter of July 15, 1978, concerning the bill H.R. 12706 and other legislative matters before the House Banking Committee.

First, I believe that mandatory universal reserve requirements may in principal be helpful in improving the accuracy of monetary control. However, enactment of mandatory universal reserve requirements at this time is premature. Such requirements are far down on the list of reforms needed to improve monetary control, and raise many important issues not related to monetary control. I believe your proposal to extend reporting requirements for depository institutions that are not now members of the Federal Reserve System is the correct step at this time. Should the Federal Reserve be unable to control the money stock accurately after a period of experience with the expanded information base, then I believe it might be desirable to reconsider mandatory universal reserve requirements.

Second, I heartily endorse proposals to tie the Federal Reserve discount rate to the Treasury bill rate and to end Federal Reserve authority to adjust reserve requirements. Discount rate and reserve requirement adjustments are clearly unnecessary for monetary control. Federal Reserve use of these policy instruments has in the past frequently distracted attention from the important issue of ensuring that money growth does not follow a procyclical path. An excellent example of what I am talking about occurred as recently as late 1974-early 1975. As you can see from the enclosed reprint of an article of mine discussing monetary policy in that period, the Federal Reserve repeatedly appealed to discount rate and reserve requirement reductions as evidence that it was following an expansionary monetary policy when, in fact, money growth was declining substantially during the worst recession since the Great Depression. I want to call your attention particularly to pages 133-36 of the reprint; you might want to place this material in the record to support your proposal to end the Fed's authority to adjust the discount rate and reserve requirements.

Third, I endorse proposals to require the Federal Reserve to charge for its services, not only because government agencies should not provide services for free when there is every reason to believe that the free services may be going to individuals and firms with fully adequate incomes, but also because the efficiency of the provision of the services will be improved if the Federal Reserve sees itself in direct competition with private firms that might provide services at lower cost.

Fourth, I believe that your cost estimates are partly misleading and partly in error. To understand the problem, note first that your estimates include a correctly calculated allowance for the revenue loss from released reserves. As you explain, this revenue loss arises from the Federal Reserve sales of government securities required to neutralize the monetary impact of reduced reserve requirements, and the interest on those securities therefore accrues to private sector owners rather than to the Federal Reserve. The same consideration, however, must be allowed for in calculating the revenue loss from the payment of interest on reserves. If interest is paid on reserves, then we may confidently predict that there will be a larger number of banks belonging to the Federal Reserve System than if no interest is paid on reserves. Thus, it is incorrect to take the present reserve base and multiply by an assumed interest rate to be paid on those reserves. Paying a higher rate of interest on reserves might actually <u>reduce</u> the cost to the Treasury; if enough banks are persuaded to join the System, then the monetary impact of the higher reserves held will be offset by Federal Reserve purchases of Treasury securities in the open market, an effect going in the opposite direction to the one you note in connection with the calculation of the revenue loss from released reserves. I should emphasize that although your cost estimates are almost surely too high for the reason just discussed, I have no feel for magnitude of the error.

Another problem with the cost estimates is that the offset due to the transfer of surplus to the Treasury should not appear at all. The reason this item is irrelevant is that a transfer of the surplus makes no difference whatsoever to the taxes paid by individuals and firms. Another way of seeing this point is to note that a transfer of the surplus could take the form of the Federal Reserve simply transfering Treasury securities from its portfolio to the Treasury. Each year the Treasury would save interest payments on those securities, but each year the transfer of Federal Reserve earnings back to the Treasury would be reduced by the same amount leaving no net effect on the Federal budget.

Finally, also with respect to the cost estimates, no allowance has been made for the effects of service charges on bank usage of Federal Reserve services. Clearly, Federal Reserve service charges will lead banks to use fewer Federal Reserve services than would otherwise be the case; the effect could be quite large if the banks decided to substitute services provided by private firms for Federal Reserve services. If this substitution were large, then the revenues produced by service charges would be smaller than the estimates in the table. However, in this event the Federal Reserve would no longer have to bear the cost of providing those services. Thus, Federal Reserve receipts from service charges would be lower than your estimates but Federal Reserve expenditures would also be lower. Whether the net effect would be to increase or to decrease the Federal Reserve surplus earnings turned over to the Treasury each year I do not know, but I am quite sure that any cost estimates that ignore the effect of service charges on the usage of Federal Reserve services is likely to be misleading.

I hope these comments are useful; if I can be of any further service please feel free to write to me again.

Sincerely,

William Poole

William Poole
Professor of Economics

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RFD South Road
Chilmark, Mass. 02535

July 24, 1978

Representative Henry S. Reuss, Chairman
Committee on Banking, Finance and Urban Affairs
U.S. House of Representatives
2129 Rayburn House Office Building
Washington, D.C. 20515

Dear Representative Reuss:

I find it a little awkward to comment line-by-line on the various proposals now before your committee. As a director of the Boston Federal Reserve Bank, which has taken the initiative within the System in urging action to deal with the attrition of membership, I would not want to undercut the Federal Reserve's proposals without prior discussion. Nor am I willing simply to follow the Fed's party line. I hope the following remarks will be useful.

(1) I think it is important to stop, or even reverse, the attrition of membership in the System. If something is not done soon, the rate of loss is likely to increase as NOW accounts or equivalents spread to other regions than New England. The main reason for wanting to do so is not the improvement of monetary control, though perhaps some small gain might be achieved on that front. A more important reason is that the Fed's function as lender of last resort in a liquidity crisis will otherwise be weakened, because the procedures for lending to nonmenber banks are slow and cumbersome. Since the main cost of membership is the reserve requirement, the payment of interest on reserve balances seems the neatest way to go.

(2) The main reason to want to price the services performed by the System in the operation of the monetary mechanism is the promotion of efficiency in resource use. Any commodity or service provided free or with only a lump-sum charge is likely to be excessively and wastefully used, and banking services are not an exception.

(3) I do not think that the net cost to the Treasury is a very important criterion of choice among alternative proposals. Congress has many ways to affect the balance of expenditure and revenue; there is no reason to believe that the current contribution of the Fed to the Treasury is somehow exactly right. But it is definitely not the purpose of these proposals to make banking a more profitable business in general, but rather to change the circumstance that it may be more profitable for a bank not to be a member than to be one. So there is good reason to accomplish the objective inexpens-

ively, and to focus any net benefits on those banks most likely to leave the System, namely small to middle-sized banks.

(4) So long as these objectives are achieved, the precise way in which they are achieved strikes me as secondary.

(5) I do not think that this legislation should be the vehicle for changing the method of operation of monetary policy. That could be left for separate treatment. I do not see the advantage of legislating precise reserve requirements, as compared with the current system of discretion within a specified range. Occasions might possibly arise in which quick changes in reserve requirements might be a better policy tool than open market operations. Nor do I see any substantial benefit from tying the discount rate to the Treasury bill rate. The discount rate now does follow market rates of interest, although irregularly; and the discount window is administered to minimize arbitrage. I do not think that the announcement effects of discount-rate changes are damaging, providing monetary policy is sensible (which is not always the case). The main point is that I think there are much more important improvements to be made in the formulation and functioning of monetary policy, and in its coordination with fiscal policy. The opportunity to make them might be lost if minor tinkering is engaged in now.

Sincerely yours,

Robert Solow

Robert M. Solow

Department of Economics
University of Maryland
College Park, Maryland 20742

July 29, 1978

The Honorable Henry S. Reuss, Chairman
House Committee on Banking, Finance and Urban Affairs
Washington, D. C. 20515

Dear Mr. Reuss:

In reply to yours of July 15, I have the following comments on the various proposals to amend the Federal Reserve Act.

My general comments are the following. First, I agree with your appraisal of the first proposal by the Federal Reserve Board. The Board can perform its legitimate functions without forcing unwilling institutions to join the System; indeed, it can perform these functions without members. Second, I agree that the Board can conduct monetary policy entirely through open market operations, and does not need either discretionary control of reserve requirements or discretionary changes in discount rates. Third, I agree that the Board needs better data on non-member assets and liabilities, and should be authorized to obtain these data, directly or through other agencies. Fourth, I agree that it is desirable that the Fed charge for its services, and that these services be available to members and non-members alike on a full-cost basis. Fifth, I agree that the Fed should pay interest on reserves. Sixth, I agree that reserve requirements can be liberalized. Seventh, I question the adequacy of your analysis of cost and advantage for the particular limitation on interest payments on reserves proposed in the Amendment to H. R. 12706. By being penny wise and possibly pound foolish in this matter, you may set the stage for wholesale losses of large-bank membership in the Fed, at a much larger cost to the Federal Budget than you estimate.

In your discussion of the costs of alternative proposals, I find no specific figures for recent losses of membership from the Fed, by bank size, nor any projections of future losses, by size, under the various proposals. These losses are evidently central to the estimation of costs to the Federal Budget of various proposals, because banks that leave the Fed gain considerable freedom in their reserve policies. To prevent an inflationary monetary expansion following such losses, the Fed would have to sell securities on the open market and so lose portfolio income. Moreover, the various proposals on which we agree, desirable though they are, have the incidental effect of increasing the likelihood that banks will leave the Fed.

It appears that if H. R. 12706, as amended, is adopted, most large banks will lose all incentive to remain members of the Fed, and that it will therefore be an open door to wholesale losses of large member banks. The Fed provides a number of essential services to which only members now have direct access, without service charges. Member banks can also go to the discount window when it is to their advantage to do so; this option is valuable even if they do not engage in "interest arbitrage." Finally, there is an element of prestige and outward security in Fed membership, likely to be important for smaller, less established banks. H. R. 12706 as amended eliminates all these advantages of membership except the third, while preserving the principal disadvantage: a severe limitation of interest to be paid on reserves so that such interest will exceed service charges with only nickles and dimes to spare. Large banks not in need of the prestige of Fed membership will find little advantage in staying; small banks will have more reason to stay. Therefore it seems perverse and gratuitous that you propose to excuse small banks but not large banks from mandatory reserve requirements. You also invite heavy membership losses, with consequent unexpected costs to the Federal Budget, when you propose to limit interest payments on reserves so severely. I think that a more careful assessment of large bank incentives will lead you to recommend a more generous policy on this matter.

As a further minor comment, I suggest in connection with the proposed Amendment to H. R. 12706, Sec. 3(d), on discount rate policy, that the Fed should set the rate a quarter to a half point above the Treasury Bill yield in the preceding two weeks. With this higher rate, discounting will be resorted to only for emergencies, at a penalty interest rate; interest arbitrage would almost never occur. Under your proposal, discounting will be attractive whenever the yield on Treasury Bills rises even slightly above its average of the previous two weeks.

However, is the discount rate policy pursued by the Fed an appropriate subject for legislation? The Federal Reserve Board now has the authority to set the discount rate in the way you or I propose. To legislate is to tell them how to run their business. I regret that they have not previously seen fit to adopt this sensible change, but doubt that the right remedy is to intrude into their management of policy. In your analysis of H. R. 13477 and the second Fed proposal, you show a proper sensitivity to the proper boundary between legislation and administrative discretion; I suggest that the same sensitivity is appropriate here. Would it not be better to adopt a separate "sense of the Congress" resolution advising the Fed that the Congress believes that open market operations are the proper vehicle for monetary policy, and that discounting should solely have the "banker of last resort" function, as it would with the suggested formula? Such a resolution would leave to the Board its present authority to conduct monetary policy, while making your views known to them forcefully. I think that is the right precedent to set and to follow.

Sincerely,

Martin J. Bailey

Correspondence From Financial Institutions

NATIONAL CREDIT UNION ADMINISTRATION
Washington, D.C. 20456

Office of the Administrator

August 10, 1978

Honorable Henry S. Reuss
Chairman
Committee on Banking, Finance and Urban Affairs
House of Representatives
Washington, DC 20515

Dear Mr. Chairman:

Thank you for your letter of July 15, 1978, requesting my comments on legislation to amend the Federal Reserve Act with respect to universal reserve requirements, payment of interest on reserves, explicit pricing of Federal Reserve services, and universal depository institution reporting requirements.

At the outset, let me point out that I view required reserves as an integral component of monetary policy implementation. Required reserves are important to monetary policy implementation, but not because the Federal Reserve changes reserve requirements to affect the money supply with any frequency -- in fact historically, changes in reserves have rarely been used for monetary policy purposes. Required reserves place a fixed upper limit on money supply growth in response to open market security purchases. The greater the volume of transaction accounts covered by fixed reserve requirements, the more able the Federal Reserve is to effectively control the money supply with open market operations.

In the absence of uniform transaction account reserve requirements, the Federal Reserve must rely almost exclusively on the Federal Funds Rate to guide monetary policy implementation. The behavior of the money supply over the past several years suggests to me the central bank needs more than merely a short term interest rate target to guide policy implementation. Uniform reserve requirements would enable more accurate control of the money supply.

It is in this context that I am sympathetic to the Board's proposal to require reserves on all transaction accounts. With respect to imposing reserves on credit unions, I have four comments.

Monetary reserves should in no sense be viewed as a source of liquidity. On the contrary, reserves constitute a withdrawal of loanable funds from financial institutions. Institutions facing a liquidity crisis are not permitted to draw upon these reserves. Therefore, until credit unions have a discount facility, such as the Central Liquidity Facility proposed in H.R. 11310, such an imposition would be counter-productive and inequitable.

Second, the legislation should be amended to specify that the National Credit Union Administration receive and pass through to the Federal Reserve those reserves imposed on credit unions. This would parallel provisions authorizing the Federal Home Loan Bank System to serve as a conduit for reserve requirements on savings and loan associations.

Third, I urge endorsement of interest payments on reserves at a level determined by money market interest rates and ask that the committee amend the legislation to enable the Federal Reserve to pay interest to the National Credit Union Administration so it, in turn, can pay interest on reserves to credit unions.

Fourth, if uniform reserve requirements on all financial institutions are imposed by Congress, I urge you to couple the expanded membership base of the Federal Reserve with an expanded representation on the boards of directors of Federal Reserve district banks and the Board of Governors. The Federal Reserve has taken tentative steps in this direction already, and I am aware and supportive of your past efforts in this regard.

In closing, I would like to add my support to the proposal to unbundle the Federal Reserve services and adopt explicit pricing policies. It is my firm belief that only by such a procedure can private electronic and paper funds transfer systems develop in a sound fashion. Similarly, I support the concept of uniform reporting requirements for monetary policy purposes.

I feel strongly, however, that credit union information should be provided by the National Credit Union Administration. Uniform reporting requirements do not add to Federal Reserve's control of the money supply to the degree that universal reserve requirements would. Nevertheless, uniform reporting would improve the Federal Reserve's understanding of the current status of the money supply and thereby enhance the accuracy of its policy implementation.

I regret that my remarks on this legislation are so brief at this time. The National Credit Union Administration is still in the process of studying the implications of the group of bills on which you have requested me to comment. Please rest assured, however, I will keep you completely informed of our position with respect to this legislation.

Warmest personal regards.

Sincerely,

Lawrence Connell

LAWRENCE CONNELL
Administrator

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SAUL B. KLAMAN
PRESIDENT

August 7, 1978

The Honorable Henry S. Reuss
Chairman
Committee on Banking, Finance
and Urban Affairs
U. S. House of Representatives
2129 Rayburn House Office Building
Washington, D.C. 20515

Dear Mr. Chairman:

This letter is in response to your invitation of July 15 to submit comments on H.R. 12706, an amendment to H.R. 12706 and other legislative matters relating to the Federal Reserve System. Our comments will be addressed to the five issues which you set forth in announcing hearings on these legislative proposals: reserve requirements for transactions accounts, payment of interest on reserves held by member banks of the Federal Reserve System, authorizing the Federal Reserve to obtain summary statistical information on all depository institutions, providing for explicit fees and compensatory charges for services offered by the Federal Reserve to depository institutions, and tying the Federal Reserve discount rate to the yield on 3-month Treasury bills.

In offering these comments, it is appropriate to reiterate that no savings bank is a member of the Federal Reserve System. Therefore, our industry does not have direct experience with some of the issues involved in these legislative proposals. On those matters where such experience may be crucial, our comments will necessarily be general, rather than detailed.

1. Reserve requirements on transactions accounts for nonmember depository institutions. It is the long-standing position of the savings bank industry that, with regard to reserve requirements on checking, NOW or other types of transactions accounts, state-chartered savings banks which are not members of the Federal Reserve System should be treated in the same way as state-chartered nonmember commercial banks. Further, we believe that required reserves on transactions accounts for state chartered nonmember institutions should be set, and held, as determined by the appropriate state authorities.

We believe that this position is consistent with effective Federal Reserve monetary policy. You have noted that "universal reserve requirements, as required by H.R. 13476, are not necessary for improved monetary controls." (Congressional Record, H-6778, July 14, 1978.) In any event, it is difficult to imagine any industry more sensitive than savings banks to Federal Reserve policy, as witness the recurrence of disintermediation and resultant cutbacks in mortgage lending activity at our institutions during periods of monetary restraint. Imposition of reserve requirements on transactions accounts are clearly unnecessary to make savings banks responsive to counter-cyclical monetary policy and would merely add to current pressures on their earnings positions, which are already mounting as a result of recent changes in Regulation Q deposit interest rate ceilings.

2. Payment interest on reserves held by Federal Reserve member banks. Although no savings banks are members of the Federal Reserve system, we have no objections to the payment of interest on reserves held by member banks. We are also sympathetic to your concern that the impact on the Federal budget should be minimized.

3. Providing for explicit and compensatory charges for services that are offered by the Federal Reserve to depository institutions. We strongly support the proposal to provide for explicit fees, uniform for all depository institutions, for automated clearing house, transfer, settlement or other services offered by the Federal Reserve. The principle of explicit and uniform fees is especially important as thrift institutions gain third party payment powers and as electronic funds transfer systems are developed and implemented. The availability of such services should in no way be contingent upon membership in the Federal Reserve System. Access to the discount window is a major advantage for System members. If the costs of Federal Reserve membership are deemed to be excessive, appropriate adjustments can be made through payment of interest on reserves, as proposed by various legislative proposals before the Committee.

4. Authorizing the Federal Reserve to obtain summary asset and liability information from all depository institutions. The Federal Reserve should have all the information needed to conduct effective monetary policy. In obtaining such information, existing sources of data should be utilized in order to avoid needless duplication of effort and excessive reporting burdens on depository institutions. Such sources of data include FDIC, FHLBB and NCUA, as well as private agencies. In this regard, the National Association has for many years been the central source of monthly, industrywide data on deposit and investment activity of mutual savings banks. We have regularly reported such information to the Federal Reserve and other regulatory agencies on a timely basis. A recent example is detailed data on savings bank industry experience with the new 6-month and 8-year time deposits, authorized as of June 1, which have been collected by NAMSB and provided to the regulatory authorities.

5. Tying the Federal Reserve discount rate to the Treasury bill rate. Changes in the discount rate at times may have undesirable effects on financial market sentiment. The possibility of arbitrage profits may also exist when the discount rate is out of line with yields on investments available to commercial banks. Nevertheless, the discount rate remains an important instrument of monetary policy. Absent compelling evidence that the proposed change is necessary, it would appear that present discretionary authority to change the discount rate should be retained by the Federal Reserve.

I hope that these comments will be helpful.

Sincerely yours,

Saul B. Klaman

Saul B. Klaman
President

Credit Union National Association, Inc.

1730 RHODE ISLAND AVE N.W. WASHINGTON D.C. 20036 · 202-659-2350

August 3, 1978

The Honorable Henry S. Reuss
Chairman, Committee on Banking, Finance
and Urban Affairs
2129 Rayburn House Office Building
U.S. House of Representatives
Washington, D.C. 20515

Dear Chairman Reuss:

Thank you for your letter of July 15, 1978, inviting the comments of the Credit Union National Association, Inc. (CUNA) on the legislation before your Committee concerning depository institution reserve requirements. No one can take issue with the point that declining Fed membership has serious public policy implications, however, I do believe that the proposal offered by Chairman Miller needs further study and analysis. While we will no doubt want to respond in detail at a later date, I can give you our initial reaction to the proposal.

While the universal reserve requirement of H.R. 13476 implicitly recognizes that transaction accounts other than traditional bank checking accounts have a legitimate and increasingly important place in our financial marketplace, the bill does nothing to extend the benefits of interest bearing transaction accounts to consumers nationwide. CUNA has supported the approach taken in S. 2055 (reported by the Senate Banking Committee on August 18, 1977) which would achieve many of the goals sought by Chairman Miller and also authorizes all depository institutions in the country to offer transaction accounts. While the $5 million threshold contained in H.R. 13476 would mean that only a very few existing credit union share draft programs would be affected, we are disturbed by the blank check authority the Board wants to impose reserve requirements on accounts below the threshold. If it is not possible for the Committee to join the issues of universal reserves and universal transaction accounts, we would favor the approach taken in your amendment to H.R. 12706 which deals only with reserve requirements of member banks.

We also have reservations about the provision of H.R. 13476 which would require all depository institutions regardless of size or type of accounts held to report directly to the Board its deposits and reserves as often as the Board may require. While we recognize the Fed's legitimate need for accurate and timely information about account balances, we would hope that the Fed would take into consideration the costs involved for smaller financial institutions in complying with its reporting requirements.

In conclusion, Mr. Chairman, we believe that the issues raised by the Fed proposal (i.e. payment of interest on reserves, pricing Fed services and universal reserve requirements) are properly in the purview of the Congress and should be resolved by the actions of the Congress.

I appreciate this opportunity to address these issues and hope our comments are helpful to the Committee.

Yours sincerely,

David S. Wright

David S. Wright
Chairman of the Board

National Savings and Loan League

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William L. Reynolds
Executive Director

August 1, 1978

The Honorable Henry S. Reuss
Chairman
House Committee on Banking,
Finance & Urban Affairs
2129 Rayburn House Office Building
Washington, D. C. 20515

Dear Mr. Chairman:

We appreciate the opportunity to submit our comments on H.R. 12706 and other bills relating to the Federal Reserve System.

We are extremely concerned over the repetitious power-seeking proposals submitted by the Federal Reserve Board, which would require S&Ls to maintain unnecessary reserves with the Federal Reserve System, which we have continuously and vigorously opposed for decades. We are also opposed to those provisions which would authorize the annual payment of as much as $500 million or more per year to commercial banks from monies which are now paid into the United States Treasury.

Mr. Chairman, we agree entirely with your considered observations that the proposed provisions relating to sterilizing a portion of savings account balances will result in a major unwarranted extension of the regulatory jurisdiction of the Federal Reserve and that this proposed extension of power will seriously upset the long-established regulatory jurisdictions of the various financial institution regulatory agencies. Without question, any objective analysis of cost versus benefit, and the resultant unnecessary pyramiding of bureaucratic regulation and control would conclude that the power extension sought by the Fed is unsupportable either theoretically or pragmatically.

We would also suggest that the payment of interest on reserves held at the Fed would amount to nothing more than an unnecessary and unjustifiable subsidy to the commercial banking industry. There is already too much legislative and tax disparity among financial institutions in favor of commercial banks, such as an effective Federal tax rate for banks at almost half the rate paid by S&Ls.

The Federal Reserve Board does not need control over non-bank reserves in order to adequately conduct monetary policy. Indeed, there is some question as to whether the manipulation of even the reserves they presently control is the most appropriate way to control the money supply.

There is one very important distinction between the reserves of thrift institutions and those presently held by commercial banks at the Fed. Banks are required to maintain monetary reserves because of their vital relationship to the money creation process. Transaction account authority, that may one day be available to all S&Ls, does not involve the money creation process as do loans created by the fractional reserve commercial banking system and, consequently, does not require the maintenance of monetary reserves as does membership in the Federal Reserve System. Transaction accounts such as NOW accounts and the settlement of these accounts does not involve new loans and new deposits within the thrift industry. These transactions are merely the transfer of existing savings (not created by the fiat of the money printing press) to others for the payments of existing debts. Reserves required to support these accounts are strictly liquidity holdings in the institution involved and not funds sheltered for monetary purposes in some distant Federal Reserve Bank.

A significant undesired result of the Fed's proposal would be aimed directly at the consumer. There is no reason why the home seeking consumer should be subjected to an increase in his mortgage costs, which are already extremely high, for the sole purpose of permitting the Fed to expand its regulatory jurisdiction or to make it more profitable for a bank to be a member of the Federal Reserve System.

When S&Ls are forced to idle their money in uncompensated and unnecessary reserves, the result obviously will be an equally unnecessary increase in the cost of mortgage money.

We are frankly surprised that the Fed persists in its attempts to gain this authority over home mortgage lending institutions. The proposed universal reserve requirements are but another attempt by the Fed to gain control over and impose its will upon more and more of the nation's financial institutions. You and your Committee are no strangers to the Federal Reserve Board's constant attempts to enlarge its control over the nation's financial transactions.

In previous hearings by both the Senate and House Banking Committees, the Federal Reserve Board has proposed that all commercial banks be required to be members of the System. The Congress has never endorsed these proposals. We commend your wisdom in consistently opposing the Fed's proposals.

During Senate and House Banking Committee hearings on the Financial Institutions Act and the Financial Reform Act, the Federal Reserve Board urged that reserves be maintained by thrift institutions with the System on certain new account authority contained in those bills. The Congress did not adopt those recommendations.

Now the Fed is coming back with yet another reserve proposal that would be applicable to all depository financial institutions, including credit unions, on "transaction accounts". We urge you to respond to this recommendation as you have on prior occasions.

The Fed has conveniently omitted from its current proposal its prior legislative recommendation requiring all commercial banks to be System members and maintain reserves with it. Rather than going after the institution, it now proposes to go after the account. Moreover, it also proposes to "sweeten the reserve kitty" by handing over, primarily to its current members, some $500 million, or more, annually which belongs to the Federal Treasury.

Mr. Chairman, after reviewing the material which you provided us and on the basis of the foregoing reasons, we completely support H.R. 12706, the Federal Reserve Membership Act of 1978 and we also support your amendments to that bill. This bill, as you would amend it, will not only provide benefits for the homebuying public by not placing unnecessary and costly reserve requirements on savings and loan associations which provide the overwhelming majority of the nation's housing mortgage credit, but it will also provide enormous savings to the U. S. Treasury which will benefit every taxpayer in the country.

We appreciate the opportunity to submit our comments on these important issues and hope that they will be useful to you.

Sincerely,

William D. Reynolds
Executive Director

Other Correspondence

Federal Home Loan Bank Board

1700 G Street, N.W.
Washington, D.C. 20552

Federal Home Loan Bank System
Federal Home Loan Mortgage Corporation
Federal Savings and Loan Insurance Corporation

ROBERT H. McKINNEY
Chairman

August 3, 1978

The Honorable Henry S. Reuss
Chairman
Committee on Banking, Finance and
 Urban Affairs
United States House of Representatives
Washington, D.C.

Dear Mr. Chairman,

This is in response to your request for the Bank Board's comments on H.R. 12706 and other legislative matters before the Committee, including two proposals by the Federal Reserve System and an amendment to H.R. 12706. These proposals have as their common goal the enhanced efficiency and competitiveness of our financial system and improvement of the conduct of monetary policy.

In preparing our comments, we have focused on the topics raised by the various legislative proposals rather than analyze the provisions of each proposal. We have also limited our comments to subjects which most directly affect the Bank Board and the savings and loan industry.

<u>Interest on Reserves</u>

We are commenting on the topic of the payment of interest on reserves because the Bank Board permits interest bearing assets to be held to meet liquidity requirements which, although not strictly comparable to reserves, are used to influence mortgage credit availability. Members of the Federal Home Loan Bank System are required by statute, Section 5A of the Federal Home Loan Bank Act (12 U.S.C. 1425a) to hold a certain amount of their assets in liquid form which may not be less than 4% or more than 10% of their obligation on withdrawable accounts and borrowings payable on demand or with unexpired maturities of one year or less. The present liquidity requirement is 6.5% which the Bank Board recently lowered from 7% to add to the flow of funds in the mortgage market. The statute specifically permits member institutions to maintain their liquidity requirements in the form of cash, time and savings deposits in Federal Home Loan Banks and commercial banks, government obligations, and bankers acceptances as approved by the Bank Board.

The Federal Home Loan Bank System has not had a membership problem with savings and loan associations because FSLIC-insurance of accounts requires Bank System membership. This has made it possible for the Bank Board to set liquidity requirements without consideration of any negative impact on earnings that result from the fact that liquid assets usually carry a lower interest rate then mortgage loans. In contrast, there is a membership problem in the Federal Reserve System since membership is optional for State-chartered banks, even though they have Federal insurance of accounts. It is the Bank Board's view that the payment of interest on reserves would be one effective way of dealing with the Federal Reserve membership problem. Certainly members would be less likely to leave the System and additional members might be induced to join if reserves were interest earning. Moreover, payment of explicit interest on reserves makes pricing of Federal Reserve services feasible. And it also should be noted that the payment of interest on reserves facilitates recipient depository institutions' payment of interest on their depositors' funds. While we thus see the merit of such provisions in H.R. 13477 and H.R. 12706, we express no opinion on how interest should be paid on reserves.

Universal (Mandatory) Reserve Requirements

The Bank Board does not favor the imposition of reserve requirements against the transaction accounts of savings and loan associations for three reasons.

First, we understand that the Federal Reserve Board has presented its interest on reserves proposal and its universal reserves proposal as alternatives. We favor the interest on reserves proposal because, if the Federal Reserve System can pay interest on reserves, it should be an inducement for member banks to remain in the System and for additional commercial banks to join the System. This, in turn, should provide enough leverage for the conduct of monetary policy without the need to require reserves against the transaction accounts of all depository institutions.

Second, it should be recognized that the amount of the deposits held by savings and loan associations in transaction accounts is very small. Savings and loan associations may offer N.O.W. accounts presently only in the New England States. Checking or N.I.N.O.W. account authority for State-chartered associations exists in only a few States outside of New England. In the aggregate all savings and loan associations offering N.O.W. accounts hold only $293 million in such deposits, and the average N.O.W. deposit for such institutions is $940. Compared to commercial bank demand and N.O.W. accounts of $258 billion, this is a very insignificant amount.

Third, we do not believe that reserve requirements should be imposed on savings and loan associations for reasons of equity or competitive balance. First savings and loan associations do have to meet liquidity requirements, as described above, at present. While they can carry these in interest bearing liquid assets, such assets normally yield less than mortgage loans and depress earnings.

But the question of competitive parity goes beyond just the treatment of reserves. In the overall area of their asset and liability powers, savings and loans are still considerably less than equal competitors with commercial banks. Savings and loan associations also have a higher tax rate than their commercial bank competitors.

Therefore, the Bank Board does not believe that there is a need for or benefit to be gained from the universal reserves proposal.

Pricing for Services

The Bank Board is in full support of the proposal for explicit pricing of services provided by the Federal Reserve Banks and for direct access to those services by all depository institutions. Unbundling of services should improve competition in the provision of services and, since the services would be priced, there would no longer be a justification for excluding non-member depository institutions from direct access to such services.

The Bank Board appreciates the opportunity to comment on these important legislative proposals and would be pleased to provide any further information which the Committee requests.

Sincerely,

Robert H. [signature]

Chairman