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Statement of

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Chairman Shelby, Senator Sarbanes, and members of the Committee, thank you for the opportunity to testify on issues related to regulatory relief. The Federal Reserve strongly supports this and other efforts to review the federal banking laws periodically to determine whether they may be streamlined without jeopardizing the safety and soundness of this nation's insured depository institutions or undermining consumer protection or other important policy principles that Congress has established to guide the development of our financial system.

Earlier this spring, Chairman Shelby and Senator Crapo asked the Federal Reserve Board to identify its top two or three legislative priorities for regulatory relief. In his letter of April 23, Chairman Greenspan highlighted three proposals that the Board has supported for many years: authorization for the Federal Reserve to pay interest on balances held by depository institutions in their accounts at Federal Reserve Banks, repeal of the prohibition against the payment of interest on demand deposits by depository institutions, and increased flexibility for the Federal Reserve in setting reserve requirements.

As we have previously testified, unnecessary legal restrictions on the payment of interest on demand deposits at depository institutions and on balances held at Reserve Banks distort market prices and lead to economically wasteful efforts by depository institutions to circumvent these artificial limits. In addition, authorization of interest on all types of balances held at Reserve Banks would enhance the toolkit available for the continued efficient conduct of monetary policy. And the ability to pay interest on a variety of balances, together with increased authority to lower or even eliminate reserve requirements, could allow the Federal Reserve to reduce the regulatory and reporting burden on depository institutions of reserve requirements. Let me explore each of these topics at greater length.

Interest on Reserves and Reserve Requirement Flexibility

For the purpose of implementing monetary policy, the Federal Reserve is obliged by law to establish reserve requirements on certain deposits held at depository institutions. Banks, thrifts, and credit unions may satisfy their reserve requirements either by holding cash in their vaults and ATM machines, which they need in any case for normal business activities, or by holding balances at Reserve Banks. Because no interest is paid on the balances held at Reserve Banks to meet reserve requirements, depositories have an incentive to reduce their reserve requirements to a minimum. To do so, they engage in a variety of reserve avoidance activities, including sweep arrangements that move funds from deposits that are subject to reserve requirements to those that are not and to money market investments. These sweep programs and similar activities absorb real resources and therefore diminish the efficiency of our banking institutions. The payment of interest on required reserve balances would remove a substantial portion of the incentive for depositories to engage in such reserve avoidance measures, and the resulting improvements in efficiency should eventually be passed through to bank borrowers and depositors.

Although paying interest on reserves would yield significant benefits, even greater efficiencies and regulatory burden reduction might be realized by substantially reducing, or even eliminating, reserve requirements. To understand how elimination of reserve requirements could be consistent with effective monetary policy and the other legislative changes that would be necessary to realize this greater reduction in regulatory burden, I need to review with you the role of reserve requirements in the implementation of monetary policy and alternatives that might be possible.

The Federal Reserve's Federal Open Market Committee (FOMC) conducts monetary policy by setting a target for the overnight federal funds rate–the interest rate on loans between

depository institutions of balances held at Reserve Banks. While the federal funds rate is a market interest rate, the Federal Reserve can strongly influence its level by adjusting the aggregate supply of balances held at Reserve Banks. It does so through open market operations–the purchase or sale of securities that causes increases or decreases in such balances. However, in deciding on the appropriate level of balances to supply in order to achieve the targeted funds rate, the Federal Reserve's Open Market Desk must estimate the aggregate demand for such balances.

At present, a depository institution may hold three types of balances in its account at a Federal Reserve Bank–required reserve balances, contractual clearing balances, and excess reserve balances. As noted above, required reserve balances are the balances that a depository institution must hold to meet reserve requirements. A depository institution holds contractual clearing balances when it needs a higher level of balances than its required reserve balances in order to pay checks or make wire transfers out of its account at the Federal Reserve without incurring overnight overdrafts. Currently, such clearing balances do not earn explicit interest, but they do earn implicit interest for depository institutions in the form of credits that may be used to pay for Federal Reserve services, such as check clearing. Finally, excess reserve balances, which earn no interest, are funds held by depository institutions in their accounts at Reserve Banks in excess of their required reserve and contractual clearing balances.

To conduct policy effectively, it is important that the combined demand for these balances be predictable, so that the Open Market Desk knows the volume of reserves to supply to achieve the FOMC's target federal funds rate. Required reserve and contractual clearing balances are predictable in that depository institutions must maintain these balances over a two-week maintenance period, and the required amounts of both types of balances are known in advance. It is also helpful for policy implementation that, when the level of balances unexpectedly deviates

from the desk's intention, banks engage in arbitrage activities that help to keep the funds rate near its target. Depository institutions have an incentive to engage in this arbitrage activity because required reserve and contractual clearing balances must be maintained, not day-by-day, but only on an average basis over a two-week period. Thus, for example, if the funds rate were higher than usual on a particular day, some depository institutions could choose to hold lower balances on that day, and their reduced demand would help to alleviate the upward pressure on the funds rate. Later in the period, when the funds rate might be lower, those institutions could choose to hold extra balances to make up the shortfall in their average holdings of reserve balances.

The averaging feature is only effective in stabilizing markets, however, if the sum of required reserve and contractual clearing balances is sufficiently high that banks hold balances, on the margin, as a means of hitting their two-week average requirements. If the sum of required reserve and contractual clearing balances declined to a very low level so that depositories held balances at Reserve Banks on the margin only to meet possible payments out of their accounts late in the day, the demand for balances would be more variable from day to day and more difficult to predict. While overnight interest rates have exhibited little volatility in recent years, even when the sum of required and contractual balances was considerably smaller than at present, volatility nevertheless could potentially become a problem at some future time if such balances fell to very low levels. Such a development might be possible if interest rates were to rise to high levels, which would reduce the demand for required and contractual balances and provide extra incentives for reserve avoidance. Paying interest on such balances is one way to ensure that they do not drop too low.

If increased flexibility in setting reserve requirements were authorized, the Federal Reserve nonetheless could consider substantial reductions in reserve requirements, or even their eventual

removal, as long as balances held at Reserve Banks other than required reserve balances could serve the purpose of ensuring the effective implementation of monetary policy. To enable the alternative types of balances to play a more important policy implementation role, it would be essential for the Federal Reserve to be authorized to pay explicit interest on them. In particular, in the absence of reserve requirements, the Federal Reserve would need to be able to pay explicit interest on contractual clearing balances or a similar type of voluntary instrument maintained over a two-week average period. This could potentially provide a demand for Federal Reserve balances that would be high and stable enough for monetary policy to be implemented effectively through existing procedures for open market operations, even with lower or zero required reserve balances.

A number of other countries, including Canada, Switzerland, Sweden, Australia, and New Zealand, have found that they are able to implement monetary policy satisfactorily without the aid of reserve requirements. One method central banks in some of these countries employ to mitigate potential volatility in overnight interest rates is to attempt to establish a ceiling and floor for such rates through the central bank's own lending and deposit rates. If a central bank lends freely at a penalty interest rate, that rate tends to act as a ceiling on overnight market interest rates. Last year, the Federal Reserve changed its discount window operations to institute a lending facility of this type that should help to mitigate large upward spikes in overnight interest rates. If the Federal Reserve had the authority to pay interest on excess reserve balances, and did so, that interest rate would act as a minimum for overnight interest rates, because banks would not generally lend to other banks at a lower rate than they could earn by keeping their excess funds at the Federal Reserve. However, our depository institutions are much more heterogeneous than those in other countries and it is not entirely clear how well a ceiling and floor arrangement would work in the United States. Although the Federal Reserve sees no need to pay interest on excess reserves in the

near future, the ability to do so nevertheless would be a potentially useful addition to the monetary toolkit of the Federal Reserve.

Interest on Demand Deposits

The efficiency of our financial sector also would be improved by repealing the prohibition of interest on demand deposits. This prohibition was enacted during the Great Depression, due to concerns that large money center banks might have earlier bid deposits away from country banks to make loans to stock market speculators, depriving rural areas of financing. It is doubtful that the rationale for this prohibition was ever valid, and it is certainly no longer applicable. Today, funds flow freely around the country, and among banks of all sizes, to find the most profitable lending opportunities, using a wide variety of market mechanisms, including the federal funds market. Moreover, Congress authorized interest payments on household checking accounts with the approval of nationwide NOW accounts in the early 1980s. The absence of interest on demand deposits, which are held predominantly by businesses, is no bar to the movement of funds from depositories with surplus funds–whatever their size or location–to the markets where the funding can be profitably employed. Moreover, in rural areas, small firms with extra cash are able to bypass their local banks and invest in money market mutual funds with check-writing and other transaction capabilities. Indeed, smaller banks have complained that they are unable to compete for the deposits of businesses precisely because of their inability to offer interest on demand deposits.

The prohibition of interest on demand deposits distorts the pricing of transaction deposits and associated bank services. In order to compete for the liquid assets of businesses, banks have been compelled to set up complicated procedures to pay implicit interest on compensating balance accounts. Banks also spend resources–and charge fees–for sweeping the excess demand deposits

of businesses into money market investments on a nightly basis. To be sure, the progress of computer technology has reduced the cost of such systems over time. However, the expenses are not trivial, particularly when substantial efforts are needed to upgrade such automation systems or to integrate the diverse systems of merging banks. From the standpoint of the overall economy, such expenses are a waste of resources and would be unnecessary if interest were allowed to be paid on both demand deposits and the reserve balances that must be held against them.

The prohibition of interest on demand deposits also distorts the pricing of other bank products. Many demand deposits are not compensating balances, and because banks cannot pay explicit interest, they often try to attract these deposits by pricing other bank services below their actual cost. When services are offered below cost, they tend to be overused to the extent that the benefits of consuming them are less than the costs to society of producing them.

Interest on demand deposits would clearly benefit small businesses, which currently earn no interest on their checking accounts. But larger firms would also benefit as direct interest payments replaced more costly sweep and compensating balance arrangements. For banks, paying interest on demand deposits likely would increase costs, at least in the short run. However, to the extent that banks were underpricing some services to attract these "free" deposits, those prices would adjust to reflect costs. Moreover, combining interest on demand deposits with interest on required reserve balances and possibly a lower burden associated with reduced or eliminated reserve requirements would help to offset the rise in costs for some banks. Many banks will benefit from the elimination of unnecessary costs associated with sweep programs and other reserve-avoidance procedures.

Over time, these measures should help the banking sector attract liquid funds in competition with nonbank institutions and direct market investments by businesses. Small banks

in particular should be able to bid for business demand deposits on a more level playing field *vis-a-vis* both nonbank competition and large banks that currently use sweep programs for such deposits.

The payment of interest on demand deposits would have no direct effect on federal revenues, as interest payments would be deductible for banks but taxable for the firms that received them. However, the payment of interest on required reserve balances, or reductions in reserve requirements, would lower the revenues received by the Treasury from the Federal Reserve. The extent of the potential revenue loss, however, has fallen over the last decade as banks have increasingly implemented reserve-avoidance techniques. Paying interest on contractual clearing balances would primarily involve a switch to explicit interest from the implicit interest currently paid in the form of credits, and therefore would have essentially no net cost to the Treasury.

Industrial Loan Companies

Although the Federal Reserve Board strongly supports repealing the prohibition of interest payments on demand deposits, the Board opposes any amendment–such as the one contained in H.R. 1375–that would permit industrial loan companies (ILCs) to offer NOW accounts to businesses. ILCs are state-chartered FDIC-insured banks that were first established early in the twentieth century to make small loans to industrial workers, but over time have been granted by the states many of the powers of commercial banks and in some cases now hold billions of dollars of assets. Under a special exemption in current law, ILCs that are chartered in certain states are excluded from the definition of "bank," and their parent companies are not considered "bank holding companies" for purposes of the Bank Holding Company Act. This special exemption allows *any* type of company–including a commercial or retail company–to own an FDIC-insured

bank without complying with either the limitations on activities or the consolidated supervision requirements that apply to bank holding companies under the Bank Holding Company Act. An amendment that would allow ILCs to offer NOW accounts to businesses would permit ILCs to become the functional equivalent of full-service insured banks. These expanded powers are inconsistent with both the historical functions of ILCs and the terms of their special exemption in current law. Granting these powers to ILCs would provide their owners a competitive advantage over the owners of other insured banks. Moreover, such an amendment would raise significant questions for the Congress concerning the nation's policy of maintaining the separation of banking and commerce and the desirability of permitting large, diversified companies to control insured depository institutions without consolidated supervision.

H.R. 1375 also included ILCs in a provision removing limitations on de novo interstate branching by banks. The Federal Reserve supports expanding the de novo branching authority of depository institutions. Current limitations on de novo branching are anti-competitive obstacles to interstate entry for banks and also create an unlevel playing field between banks and federal savings associations, which have long been allowed to open new branches in other states. But we also believe that Congress should not grant this new branching authority to ILCs unless the corporate owners of these institutions are subject to the same type of consolidated supervision and activities restrictions as the owners of other insured banks. With de novo branching, a large retail company could potentially open a branch of an ILC in each of the company's retail stores nationwide. As mentioned above, allowing a commercial or financial firm to operate an insured nationwide bank outside the supervisory framework established by Congress for the other owners of insured banks raises significant safety and soundness concerns, creates an unlevel competitive playing field, and undermines the policy of separating banking and commerce that Congress

reaffirmed in the Gramm-Leach-Bliley Act of 1999. These important questions should be addressed in a more comprehensive and equitable manner than would be possible in the consideration of minor amendments to legislation on demand deposits or de novo branching.

Conclusion

In conclusion, the Federal Reserve Board strongly supports, as its key priorities for regulatory relief, legislative proposals that would authorize the payment of interest on demand deposits and on balances held by depository institutions at Reserve Banks, as well as increased flexibility in the setting of reserve requirements. We believe these steps would improve the efficiency of our financial sector, make a wider variety of interest-bearing accounts available to more bank customers, and better ensure the efficient conduct of monetary policy in the future.