MEMBER BANK RESERVE REQUIREMENTS

Some Comments by Chairman Martin and a Rejoinder

Attached are the texts of two letters which deal largely with the subject of member bank reserve requirements. Both letters are addressed to Senator A. Willis Robertson, Chairman of the Senate Committee on Banking and Currency, who had them inserted in the Congressional Record.

The first letter is from the Honorable William McChesney Martin, Jr., Chairman of the Board of Governors of the Federal Reserve System, in response to a request from Senator Robertson for his comments regarding a speech by E. Sherman Adams, Vice President First National City Bank, before the National Savings Conference of the American Bankers Association in New York on April 28, 1965. The second letter presents some comments on Chairman Martin's comments.

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Letter to Senator A. Willis Robertson from the Honorable Wm. McC. Martin, Jr., Chairman of the Board of Governors of the Federal Reserve System, printed in the Congressional Record of June 7, 1965, page 12240.

June 3, 1965

Hon. A. Willis Robertson,
Chairman, Committee on Banking and Currency,
U. S. Senate, Washington, D.C.

DEAR MR. CHAIRMAN:

I was interested in seeing your letter from Mr. Giles H. Miller, Jr., of Culpeper dated May 17, referring to a recent address by Mr. E. Sherman Adams, and am glad to have this opportunity to send you a few comments.

The address by Mr. Adams dealt first with the requirements for the pledging of bank assets to secure public deposits.

In 1962 this problem was the subject of an interesting report by a committee of the New York State Bankers Association of which Mr. Adams was chairman. Thereafter the problem was studied in the Federal Reserve System. This study led to a view that the problem falls within the province of the Federal Deposit Insurance Corporation, especially if full insurance coverage for public deposits were to be considered, and that if the commercial banks favored a proposal in this area, they should take the initiative in furthering it. There was also a suggestion that the matter should be approached on the State level where the chief legal requirements for pledging of securities are imposed. In view of these opinions, the Board of Governors here has not yet felt that there was any occasion for it to take a position on this matter.

The other subject that Mr. Adams discussed was that of reserve requirements. He was very frank in espousing the view that the best requirement is simply the lowest requirement - or, in the case of savings accounts, no requirement at all. I have felt that the requirements that resulted from developments of the 1930's and 1940's were unnecessarily high, and the Board has made several reductions from those peak levels, but as you know, in addition to the reasons for still lower reserve requirements suggested by Mr. Adams, there are a good many other factors involved, the combination of which has prevented the reducing of requirements to the levels that some people might desire. These other factors are related to the role of reserve requirements in the effective functioning of monetary policy as a stabilizing force in national economic developments.

Within the general framework of favoring lower requirements, Mr. Adams also expresses concern about the treatment of the larger banks as compared with the smaller banks, under any new graduated system of requirements that might be put into effect. This leads to the question of the number of categories of requirements that there should be under any graduated system. While such a question might seem a mere technical detail, it turns out to be a matter of considerable substance, as indicated below.

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In the report of the President's Committee on Financial Institutions, to which reference was made in the Board's annual report for 1964 (pp. 200-202), it was suggested that a new graduated system of reserve requirements on demand deposits be considered, and, in such a system, that there be a very low requirement, much lower than the present requirement for country banks, for the many banks of very small size. A main purpose of such a low figure would be to avoid the strain that would be imposed on many nonmember banks, which are predominantly small banks, if they had to adhere to reserve requirements in the present range of member bank requirements. The Committee's discussion went on to suggest that the graduated system might include two other categories of requirements on demand deposits, which might correspond roughly to the present requirements of country banks and of reserve city banks.

In discussing this suggested approach with its three categories, Mr. Adams refers to a "fear of discrimination against larger banks" and he suggests that this fear "might be easily dissipated. . . simply by reducing the number of categories from three to two."

It should be remembered that the bottom category in the proposed graduated system of requirements was conceived to provide for a very low percentage of reserves on the first few million dollars of a bank's deposits, in order to take care of the special situation of very small banks. If the total number of categories were to be only two, this would imply a single percentage requirement that would apply to all deposits beyond this small first bracket. Hence, the requirements on all these deposits would be brought to the same level, which would apply alike to the deposits of medium-sized banks and to those of the largest banks which are now reserve city banks and hence subject to higher requirements. While such a change might be very welcome from the viewpoint of the present reserve city banks, it would necessitate a much greater redistribution of required reserves than if there were introduced a graduated system with three categories as envisioned in the report of the President's Committee.

Finally, I should refer back to the early part of Mr. Adams' address where he speaks of "$50 billion of banking resources which are unnecessarily, unjustifiably frozen, unavailable for meeting the credit needs of business and consumer." This may sound as if another $50 billion of loans could be made if only these resources were unfrozen. I should point out that it does not seem reasonable to believe that bank loans could now be $50 billion higher without inflationary consequences. Some kind of restraint on credit expansion would be necessary. Hence, the idea that the actions suggested by Mr. Adams would enable would-be borrowers to get more credit seems, at least in large part, illusory.

Sincerely yours,

WM McC. MARTIN, Jr.

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Letter to Senator A. Willis Robertson from E. Sherman Adams, Vice President, First National City Bank, printed in the Congressional Record of June 16, 1965, pages 13389 - 13390.

June 14, 1965

Hon. A. Willis Robertson,
Chairman, Committee on Banking and Currency,
U. S. Senate, Washington, D. C.

DEAR MR. CHAIRMAN:

If I may, I should like to comment on the reply which you recently received from the Honorable William McChesney Martin, Jr., Chairman of the Board of Governors of the Federal Reserve System, in response to your request for his comments regarding my recent speech on member bank reserve requirements, and which you had printed in the Congressional Record of June 7 (page 12240).

Chairman Martin's letter states that in my speech, I frankly espoused the view that the best cash reserve requirement for member banks is "simply the lowest requirement - or, in the case of savings accounts, no requirement at all." I would prefer to summarize my view in this regard as being that cash reserve requirements should not be substantially higher than can be justified from the standpoint of the effective functioning of monetary policy. I quoted with approval a statement in the 1964 report of the Canadian Royal Commission on Banking and Finance that reserve requirement ratios "should not be set far above the level which a well-managed institution should maintain in any event." I believe that a substantial proportion of monetary economists would agree with these propositions.

As for my advocating the elimination of the reserve requirement on savings accounts, I again have plenty of company, including the Commission on Money and Credit, the American Bankers Association, the Advisory Committee to the Comptroller of the Currency, and many economists and central bankers. This requirement serves no useful purpose and clearly discriminates unfairly against member banks as compared with other competing institutions, including non-banks, which are not compelled to maintain such a reserve against comparable accounts. To the best of my knowledge, the Federal Reserve does not contend that this situation is equitable nor that this reserve requirement contributes significantly to the usefulness of monetary policy.

In commenting on my suggestion that in designing a graduated system of reserve requirements on demand deposits based on size of bank, two categories might be preferable to three, Chairman Martin's letter states that this "would necessitate a much greater redistribution of required reserves than. . . envisioned in the report of the President's Committee (on Financial Institutions)." The phrase "redistribution of required reserves" plainly implies a reserve structure that would result in increases in required reserves for some banks as well as decreases for others. I would certainly not advocate such a high level of reserve ratios that a large number of banks would be subjected to higher reserve requirements than at present. I therefore read Chairman Martin's statement to mean that the President's Committee contemplated maintaining a relatively high reserve

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requirement ratio for larger banks. This does nothing to dispel the fear mentioned in my speech that a three-category system might discriminate rather heavily against larger banks.

Chairman Martin points out that the use of two categories instead of three would be "very welcome from the viewpoint of the present reserve city banks" and this is true, of course, for the simple reason that existing reserve requirements on demand deposits are especially burdensome for these banks. Again, I am far from being alone in advocating that this discrimination be corrected. I would also like to point out that the proposed elimination of the reserve requirement against savings deposits would be considerably more helpful, in general, to country member banks than to reserve city banks. In addition, as stated in my speech, I would have no objection to giving preferential reserve treatment to small banks provided that this does not tend to perpetuate unjustifiably high requirements for other banks.

In the concluding paragraph of his letter, Chairman Martin mentions several ideas which I gather he feels some persons might infer from my speech and which he characterizes as being "unreasonable" or "illusory". I would agree with his appraisal of these ideas and would like to point out that they are not contained in my speech.

It may perhaps have some significance that Chairman Martin does not say that either he or the Reserve Board would be definitely opposed to my suggestion for having two categories instead of three in a graduated system of reserve requirements. However, in view of the light his letter sheds on the thinking of the President's Committee, it may be that the attainment of a two-category structure, outlined in my speech, must be regarded as a distant objective to be attained by a series of stages over a period of years.

Sincerely yours,

E. SHERMAN ADAMS

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FIFTY BILLION FROZEN DOLLARS

Address by E. Sherman Adams, Vice President, First National City Bank, New York, at the 62nd National Savings Conference, American Bankers Association, New York, April 28, 1965

At the outset, let me pose this question: Will U. S. banks have sufficient lending power to finance the continuing growth of the American economy over the years ahead?

This is a real question. For the past two decades the banking system has been using up its excess liquidity. Today many banks are approaching a fully loaned position.

The recent surge of demand for business loans points up the problem. Many business firms have been using up their liquidity too and may need to rely increasingly on bank credit to finance future expansion. Will there be enough such credit to go around?

Against this backdrop, may I invite your attention to two aspects of the banking picture that I believe deserve attention:

1. The antiquated practice of pledging bank assets to secure public deposits, and

2. Our equally antiquated structure of member bank reserve requirements.

The net effect of these two arrangements is to freeze bank assets equal to more than one-fourth of the total loans of the entire commercial banking system. At the present time, roughly $35 billion of bank assets, mostly U. S. Government securities, are pledged, locked up, immobilized. And, under existing reserve regulations, member banks

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are required to maintain cash reserves amounting to over $21 billion, far more than they need for operating purposes. Put these two together and you get a total of around $50 billion of banking resources which are unnecessarily, unjustifiably frozen, unavailable for meeting the credit needs of business and consumers.

Elimination of the Pledging of Assets

Let us look first at pledged assets. Most of these are pledged to secure deposits belonging to various governmental units, from the U. S. Treasury to Central School District No. 14.

This is a singularly silly way of assuring the safety of these public deposits. The same purpose could be accomplished far more easily in several other ways without tying up large amounts of banking resources.

One way would be to extend the coverage of Federal deposit insurance to cover 100% of all public deposits. Another would be to give these deposits a preferred claim -- ahead of all other depositors -- against all of the assets of a bank that fails. A third approach would be to permit member banks to pledge their reserve balances at the Fed to secure public deposits. Why not?

Of these three, my own vote would definitely be for number two. Number three, pledging reserve balances, has an instant appeal to bankers but it could never be sold. Number one, full insurance coverage, would be simple and effective but would involve an unnecessary expansion of governmental insurance and might tend to keep FDIC assessments higher than they would otherwise be. Number two, giving public deposits priority in the event of a bank's insolvency, would provide ample protection for these deposits without any enlargement of governmental activity and virtually

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Incidentally, over the past thirty years, there has not been a single bank failure in which public depositors would have incurred any loss whatever if there had been no pledging of assets against these deposits and if, instead, these deposits had simply had a preferred claim against all of the assets of the closed bank. Who could ask for anything more?

So, there you have obsolete arrangement number one and a choice of at least two workable solutions. Either one would give commercial banks far greater flexibility in managing their assets and would substantially augment their capacity for meeting the future credit requirements of private borrowers.

Reserve Requirements Need Reform

What about reserve requirements? This subject is timely in view of the proposals relating to it which were recently put forward in the annual report of the Federal Reserve Board. These recommendations, emanating from such a source on a matter of such vital importance to banking, deserve more attention than they have thus far received.

First, by way of background, let us recall that today's relatively high reserve requirements are a relic of the Great Depression. Back in the mid-1930's, all reserve requirement ratios for member banks were doubled because of the extraordinary conditions that developed after the devaluation of the dollar in 1933-34.

Over the past two decades, some progress has been made toward getting back to a less burdensome and more rational system of requirements. However, the reserve requirement ratios have never been restored to the levels that prevailed from 1917 to 1934.

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In international competition, our present structure of reserve requirements would not come even close to winning a prize for best in show. In some countries, cash reserve requirements for commercial banks do not even exist, but in most of the leading nations where they do exist, they are lower than in the United States, in some cases much lower. In a number of countries, the central banks pay interest on the reserve balances held with them.

The report of the Commission on Money and Credit published in 1961 recommended the elimination of reserve requirements against savings and other time deposits, the elimination of the geographical classification of member banks as reserve city and country banks, and a reduction of the range of reserve requirement ratios on demand deposits. These were similar to recommendations made a few years earlier by the American Bankers Association.

In 1963 the so-called Heller Committee, a governmental interagency committee appointed by President Kennedy, recommended replacing the geographical classification of member banks with a graduated scale of reserve requirements on demand deposits based upon the size of each bank's demand deposits.

Now, in its latest annual report, the Federal Reserve Board urges serious consideration of this Heller Committee proposal. It also points out that it would be within the present authority of the Federal Reserve to establish such a structure of reserve requirements right now.

In describing the proposed new system, the Board virtually quotes the Heller Committee report. Each bank would "maintain a relatively low reserve against the first few million dollars of its net

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demand deposits, a higher reserve against its deposits above this minimum and up to a substantial figure, and a still higher reserve against its demand deposits, if any, above the latter amount".

What Would the Numbers Be?

It is obviously difficult to evaluate this proposal without some idea of what the numbers would be. For example, if the three requirement ratios were to be fixed at five, eight and ten percent, few bankers would object very strenously. On the other hand, if the ratios turned out to be considerably higher, some bankers would be strongly opposed.

The members of the Federal Reserve Board have given little indication as to what numbers they have in mind, so we can only guess. It is not exactly reassuring that their report does not state plainly that the present system of reserve requirements is unjustifiably burdensome. When we examine the Board's past record in the area of reserve requirements, we find that it is not as good as some bankers might wish but that it is certainly not all bad. In the 20 years that have elapsed since the end of World War II, there have been several reductions in reserve requirements and member banks are now permitted to count vault cash as part of their required reserves. On the basis of the ratios alone, one could say that, on the average, reserve requirements have been reduced only about one-third of the way back to the 1934 levels. However, the vault cash provision affords substantial additional relief.

So that is the record. Opinions differ as to whether, on balance, the Reserve Board deserves a merit badge for having done as much as it has or a demerit badge for not having done more.

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In any event, it would seem only reasonable to assume that in setting requirement ratios under the proposed new system, the Reserve authorities would try to avoid having very many banks end up with higher requirements than they have now. In other words, most banks would presumably get at least some reduction in their overall requirements, but just how much, is anyone's guess.

The report published last year by the Canadian Royal Commission on Banking and Finance contains some interesting comments and recommendations on this subject. One is a forthright recommendation that cash reserve requirements on demand deposits for Canadian banks be set at eight percent, period. This recommendation is clearly and fully supported by a one-sentence explanation, as follows:

> "Ratios should not be set far above the level which a well managed institution should maintain in any event."

One cannot help thinking how immeasurably the reports of the Heller Committee and the Reserve Board could have been improved by some help from the Royal Commission. If only we could dream up some inducements to offer the Canadians that might persuade them to swap us their Royal Commission on Banking and Finance for a few selected U. S. Congressmen.

What about the Size Categories?

The Reserve Board's proposed new reserve structure would presumably be of greatest benefit to smaller member banks. Some of these institutions need all the relief of this kind they can get. They are presently at a competitive disadvantage vis-a-vis non-member banks. For my own part, I would see no objection to giving them preferential

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reserve treatment provided -- and this is an essential proviso -- that this does not tend to perpetuate unjustifiably high requirements for other banks. That is a possible danger that cannot be judged until we have a better idea as to what the numbers might be.

Larger banks are naturally concerned as to how they would fare under the proposed new system. To most people, preferential treatment for small banks would suggest establishing two categories of banks: small ones and all others -- comparable with the preferential treatment of small business with respect to corporate income taxes. The proposal for three categories raises the possibility that the reserve ratios applying to large banks might be kept unduly high.

Persons who are not associated with large banks may pooh-pooh this fear. But persons who are with large banks can hardly afford to do so. Prejudice against large banks simply because of their size is by no means nonexistent. It is very real. Also, for many years, New York and Chicago banks were unfairly subjected to differentially higher reserve requirements. Having finally succeeded in correcting this inequity -- about which, by the way, the Federal Reserve seldom showed much concern -- New York and Chicago banks are hardly looking for a new system that would again discriminate against them, even though other large banks might be hurt too.

As long as the proposal is for three size categories, the fear of discrimination against larger banks is not likely to go away. It might be easily dissipated, however, simply by reducing the number of categories from three to two and by defining the small bank category.

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Regulation of Non-Member Banks

The Reserve Board makes it clear that its proposal for preferential treatment of small banks does not stem simply from concern for their welfare but also from the Board's belief that non-member banks should be subject to the same reserve requirements as member banks. The Heller Committee report minced no words on this point. It stated candidly that the proposed new reserve system favoring small banks "would faciliate a decision to bring all commercial banks under the reserve jurisdiction of the Federal Reserve".

I do not propose to analyze here the arguments for and against expanding the authority of the Federal Reserve in this way. The case for doing so is presented in the Heller Committee report, and I am sure you are all familiar with the case against doing so. However, it seems to me that this whole question is highly academic at the present time and that it will probably remain so as long as member bank reserve requirements remain so high. Until the Reserve authorities actually demonstrate their ability to achieve a more equitable reserve structure, most bankers and many others will be strongly and effectively opposed to giving them reserve jurisdiction over non-member banks.

The Most Glaring Inequity

The existing reserve requirement on savings deposits is a clear case in point. It is noteworthy that the Reserve Board's annual report discusses the matter of reserve requirements without any reference whatever to this most glaring irrationality and inequity of all.

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The cash reserve requirement against savings deposits of member banks serves no useful purpose and clearly discriminates unfairly against these banks as compared to other competing institutions, including non-banks, which are not compelled to maintain such a reserve. It is outmoded, unwarranted, illogical and inequitable. It plainly should be abolished.

Why, then, no mention of it by the Reserve Board? One can only guess. My own guess, and it is nothing more than that, is that while there must be considerable support within the System for eliminating the reserve requirement on savings deposits, there is less unanimity with respect to the treatment of other time deposits. If this is so, then the Board may prefer not to say or do anything about eliminating the requirement on savings deposits without deciding what should be done about other time deposits at the same time.

These other time deposits are admittedly a different animal than small thrift accounts. However, that definitely does not imply that there should necessarily be a cash reserve requirement against them. In fact, negotiable certificates of deposit are, in some respects, comparable with short-term Government securities, and it would certainly seem a bit weird to suggest requiring the U. S. Treasury to maintain a special 4 per cent cash reserve at the Fed against its outstanding short-term debt.

There is more to it that that, of course. My guess is that some Federal Reserve officials may not feel entirely comfortable about the rapid growth of time deposits, especially negotiable CD's, in recent years, and that they may therefore hesitate to suggest the elimination of the reserve requirement against them.

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What Course Now?

This brings us to the following questions:

1. Whether the best course now would be to explore the possible revamping of member bank reserve requirements against demand deposits along the general lines recommended by the Reserve Board, or

2. Whether, instead, to advocate a different approach to this matter, or

3. Whether it would be better to concentrate on trying to get rid of the reserve requirement against time deposits, or

4. Whether to work for reform of reserve requirements on both demand and time deposits in one package program.

It seems to me that the first of these alternatives may be at least worth exploring at the present time, especially if the Federal Reserve authorities are willing to consider cutting back the number of size categories of bank deposits from three to two. Unless there are reasons for three categories that do not meet the eye, this would seem to be very little to ask.

But I do not mean to imply that a revamping of reserve requirements on demand deposits alone will greatly reduce the opposition to giving the Fed jurisdiction over the reserve requirements of non-member banks. That will not happen, in my opinion, until the Fed goes the second mile and eliminates the reserve requirement on savings deposits.

Most non-member banks are non-member not because they dislike the Federal Reserve club but chiefly because the dues in the form of required reserves are unconscionably high. If the Fed had a more reasonable dues schedule, it might be able to attract more banks to become members instead of seeking reserve jurisdiction over non-members. I cannot guarantee that this would happen but would be glad to bet that it would.

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Complete elimination of the reserve requirement on time deposits would require legislation. Meantime, however, the Fed still has authority to reduce the requirement ratio from 4 percent to the legal minimum of 3 percent, and it would seem highly probable that this action will be taken at the first good opportunity. Until it is, the Fed's posture in the area of reserve requirements will remain something less than unequivocal.

The Big Picture

There is much more that could be said about this subject, of course. We could go on at length exploring the economic advantages of reserve reform. We could attempt to clear up some of the many misconceptions that some persons apparently have on this subject. We could tilt with economists on a variety of theoretical and technical points.

But, with some reluctance, I return to where we came in; namely, the question of whether U.S. banks will be able to finance the credit needs of our expanding American economy. We have discussed two pieces of this question, two outmoded arrangements that clearly need reform, the pledging of bank assets and the structure of bank reserve requirements. In my estimation, reform in these two areas could make a significant contribution to the future of our economy.

However, I do not wish to exaggerate the relative importance of these two pieces. Looking at the big picture, these two pieces are not that big. In the big picture, the most important element of all is bank management. Regardless of what transpires in the areas of banking legislation and regulation, the performance of the banking system over the years that lie ahead will depend, more than anything else, upon the intelligence, know-how and ingenuity of those who manage this country's commercial banks -- you and others like you

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