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Proposals on Financial Institution

Reserve Requirements and

Related Issues

Statement by

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Chairman, Board of Governors of the Federal Reserve System

before the

Committee on Banking, Finance and Urban Affairs

House of Representatives

July 27, 1978

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 Over the past 8 years 430 member banks have withdrawn from the System, while only 103 nonmember banks have joined, as is illustrated in Chart I. In 1977 69 banks chose to give up their membership, and 39 more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 nonmembers, 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



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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 $\frac{1}{2}$ 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

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

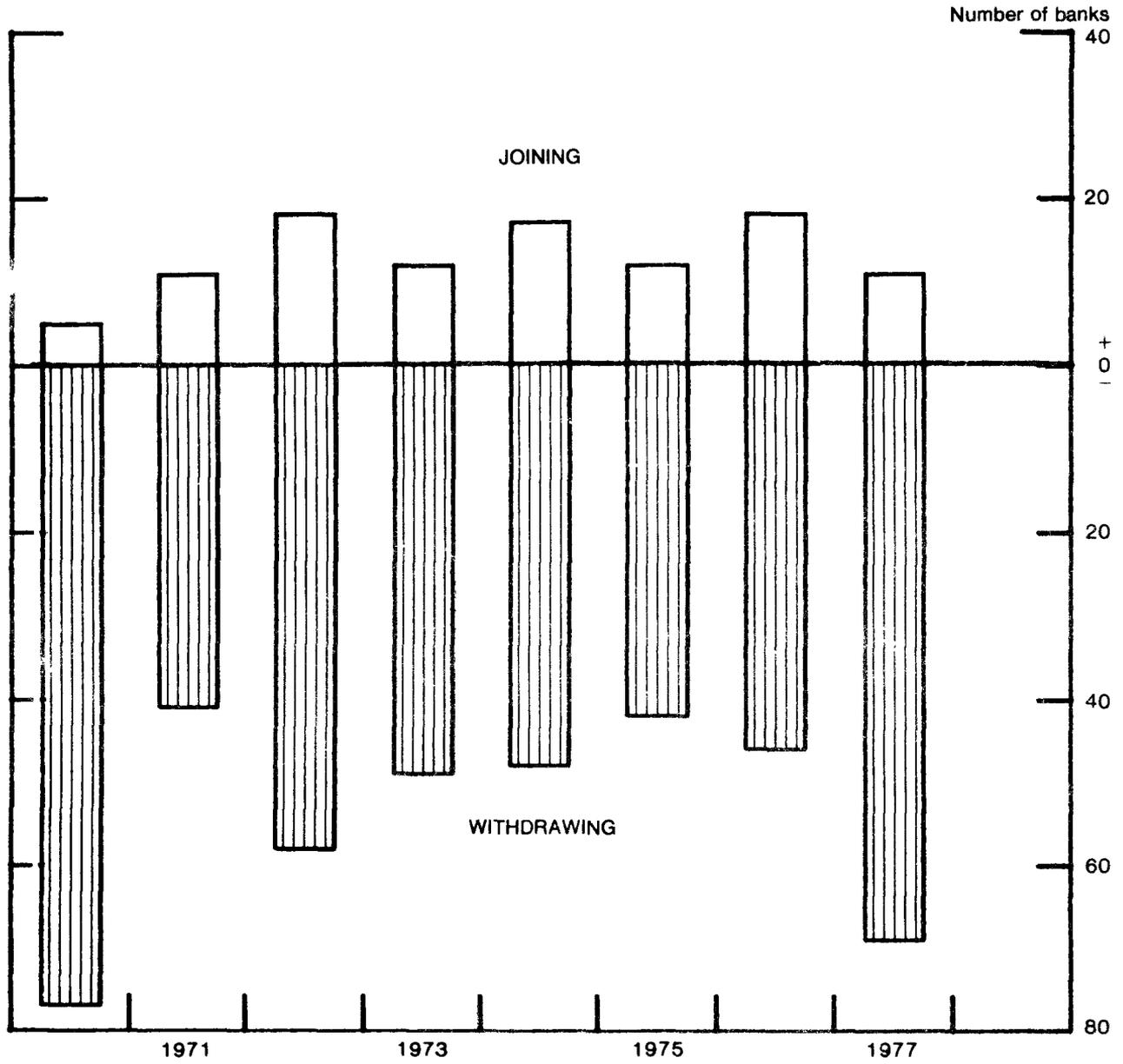


Chart II

Percentage of Banks Withdrawing from the Federal Reserve System

By Size of Bank

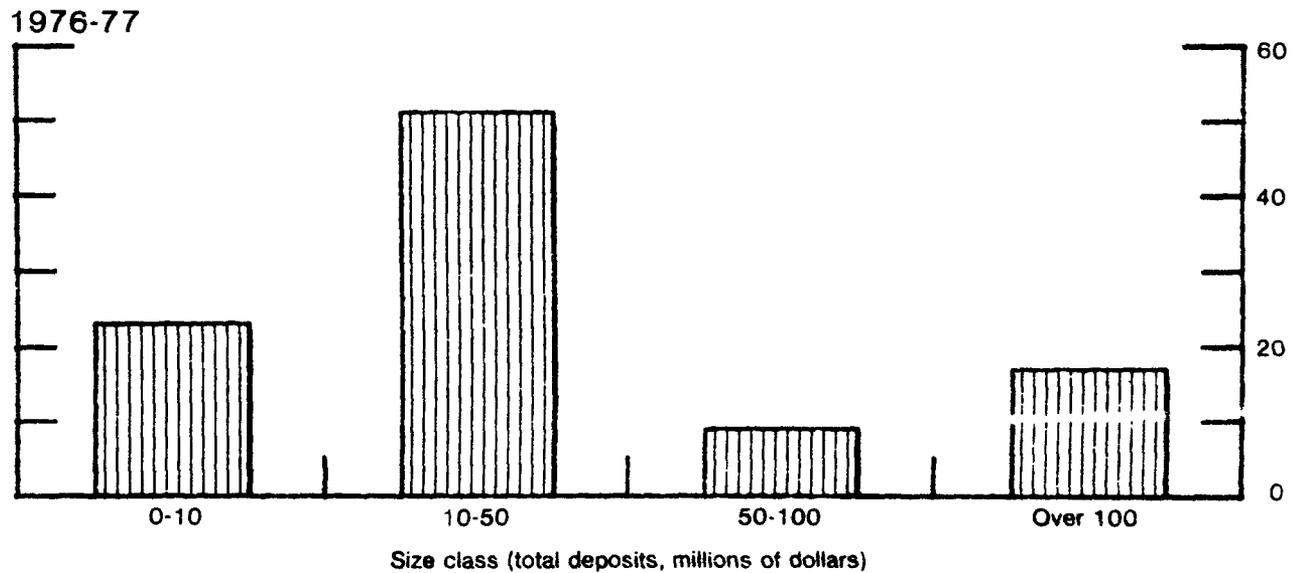
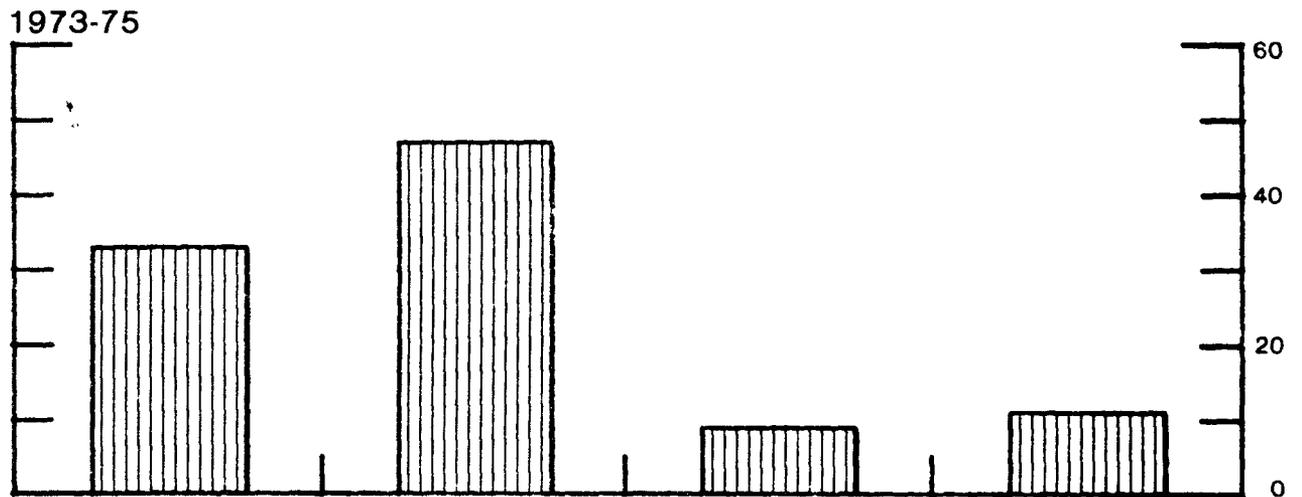
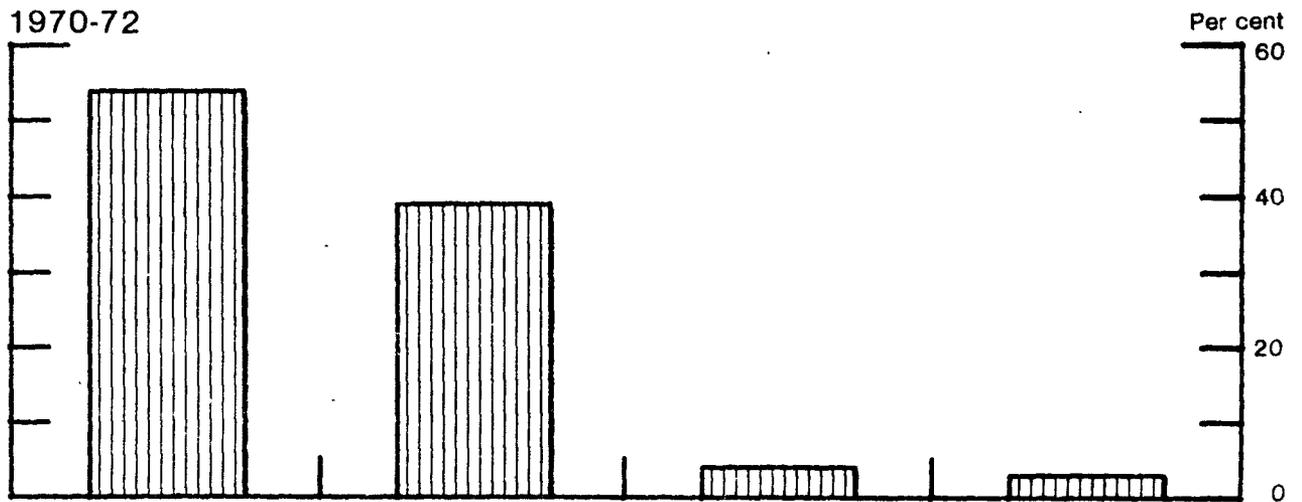


Chart III

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

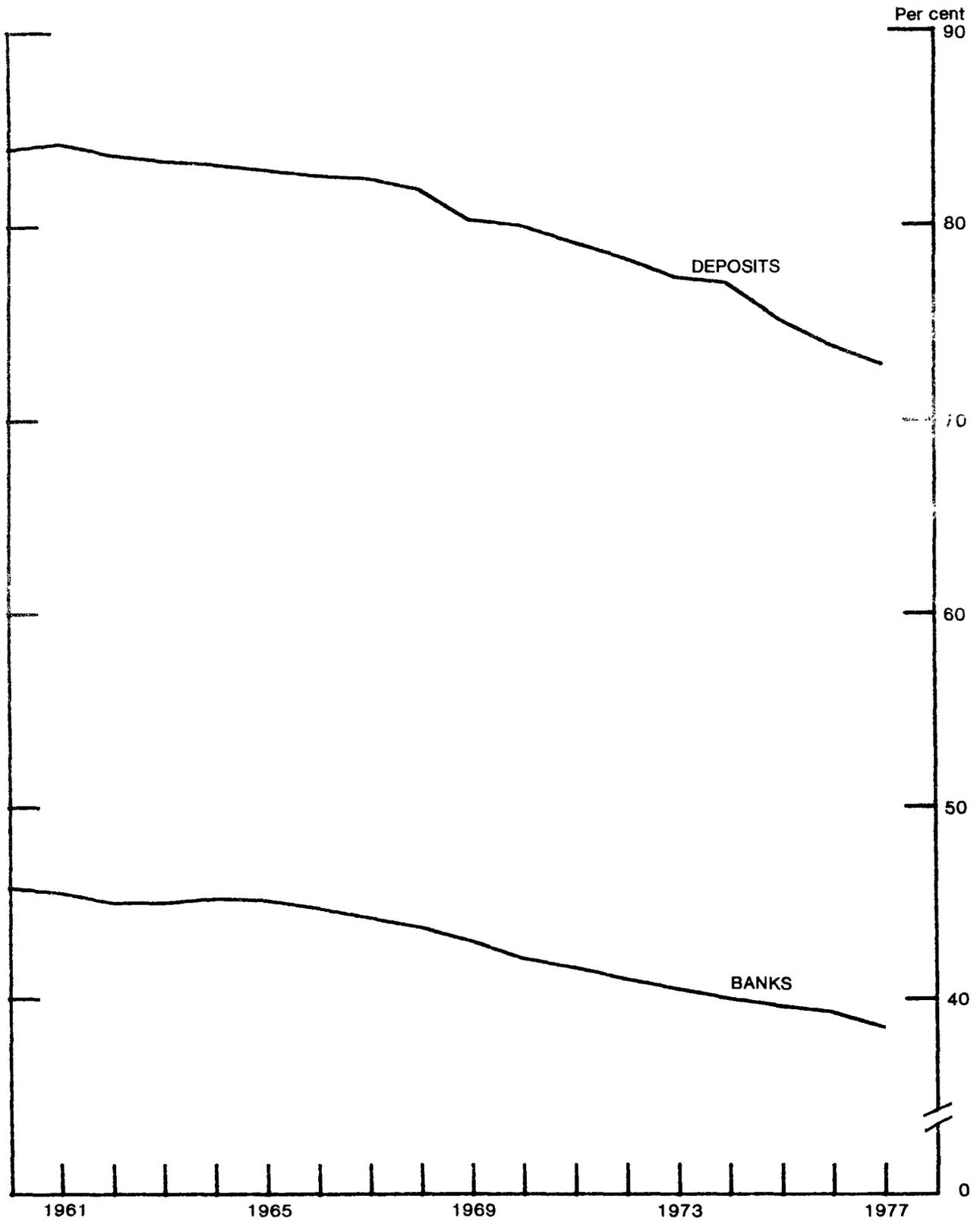


Chart IV

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

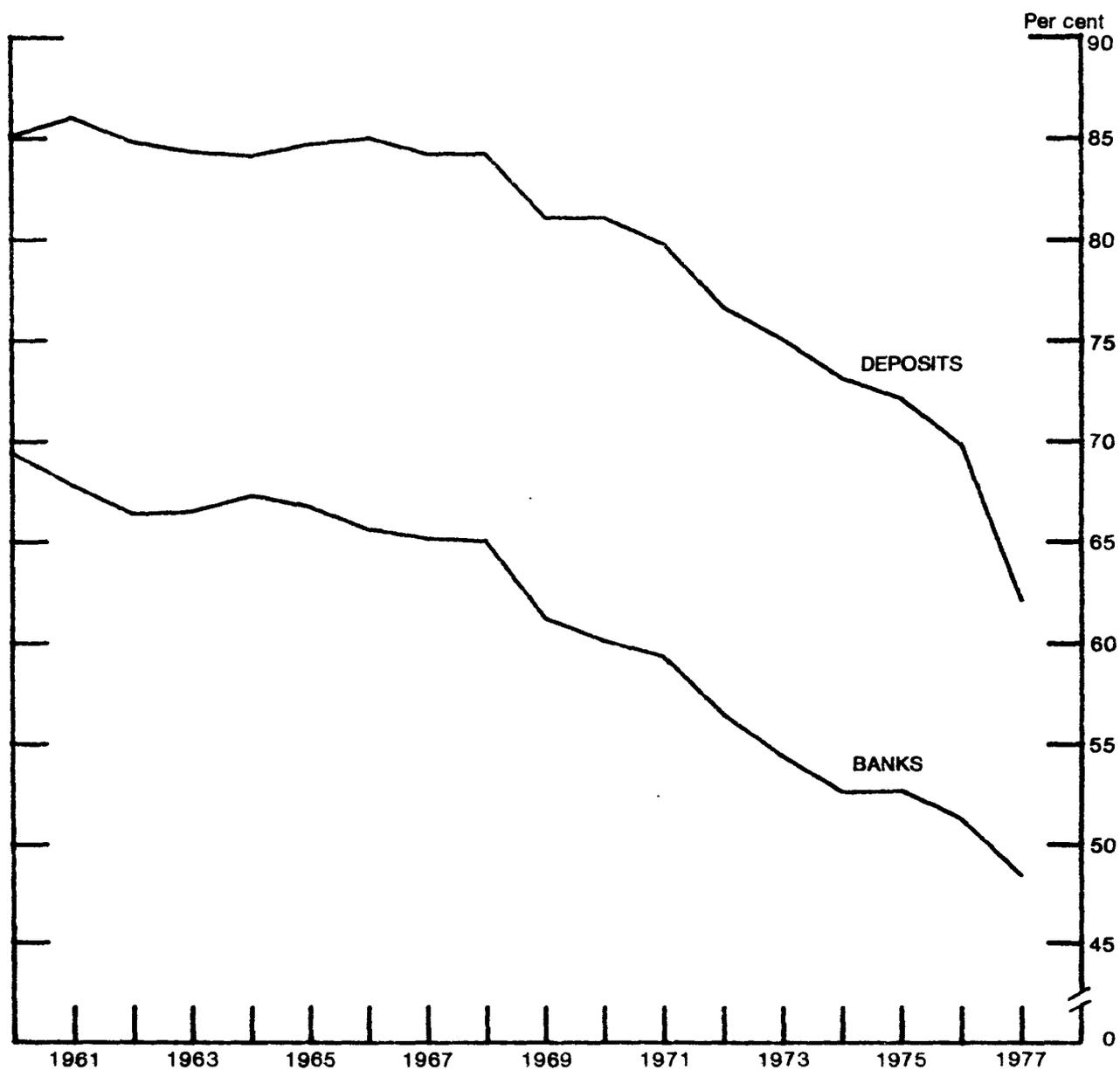


Chart V

Relative Cash Asset Positions of Member and Nonmember Banks Average Ratio of Cash Assets to Total Assets

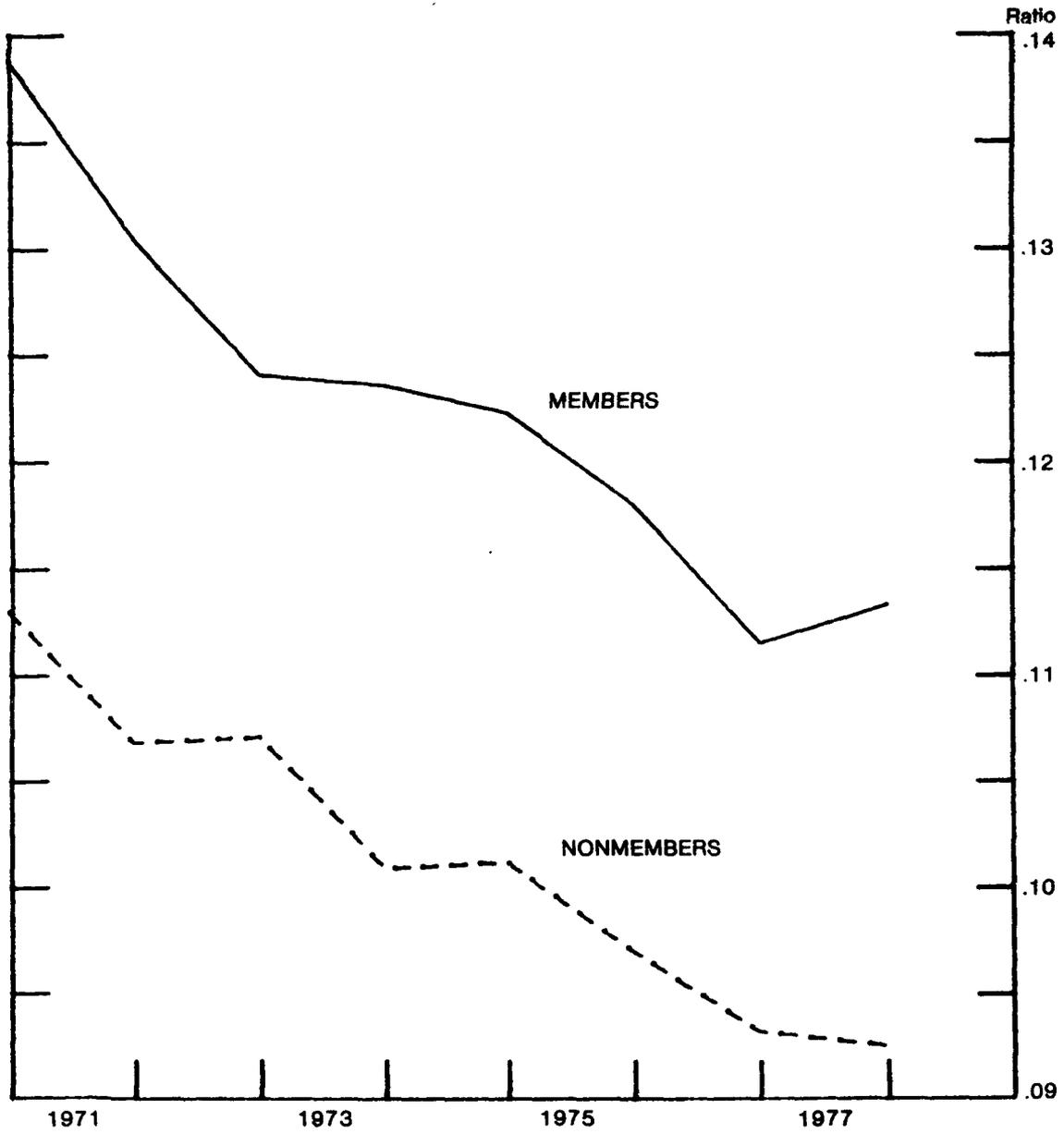
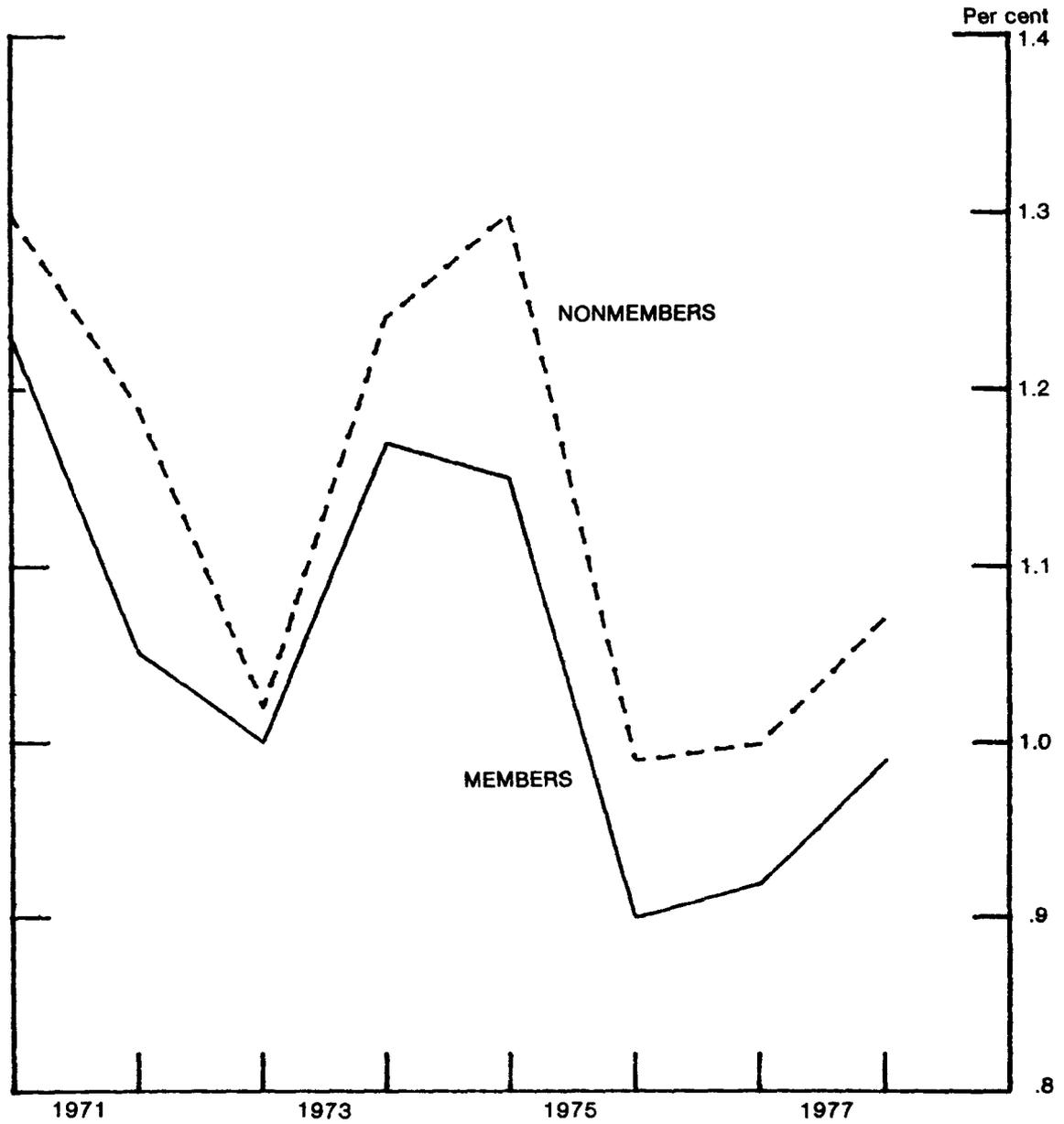


Chart VI

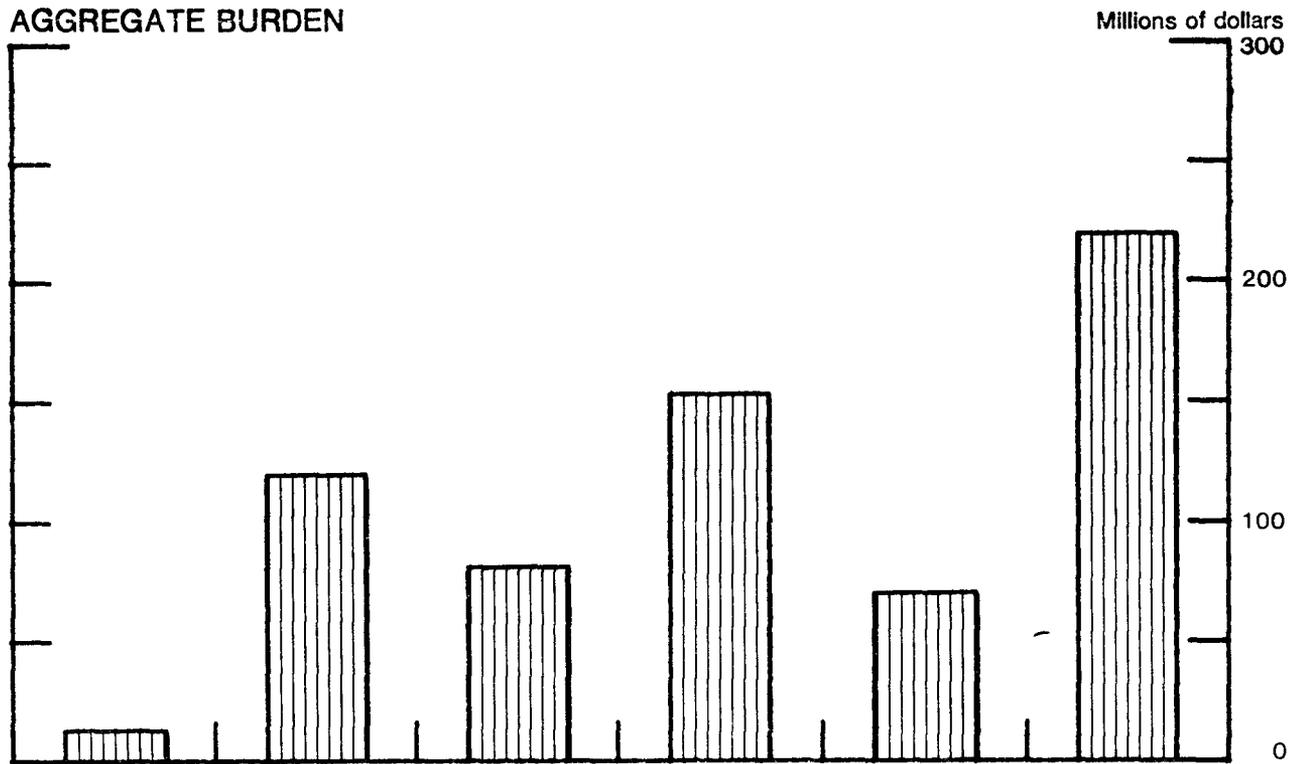
Profitability of Member and Nonmember Banks

Pre-Tax Profits as a Per Cent of Total Assets

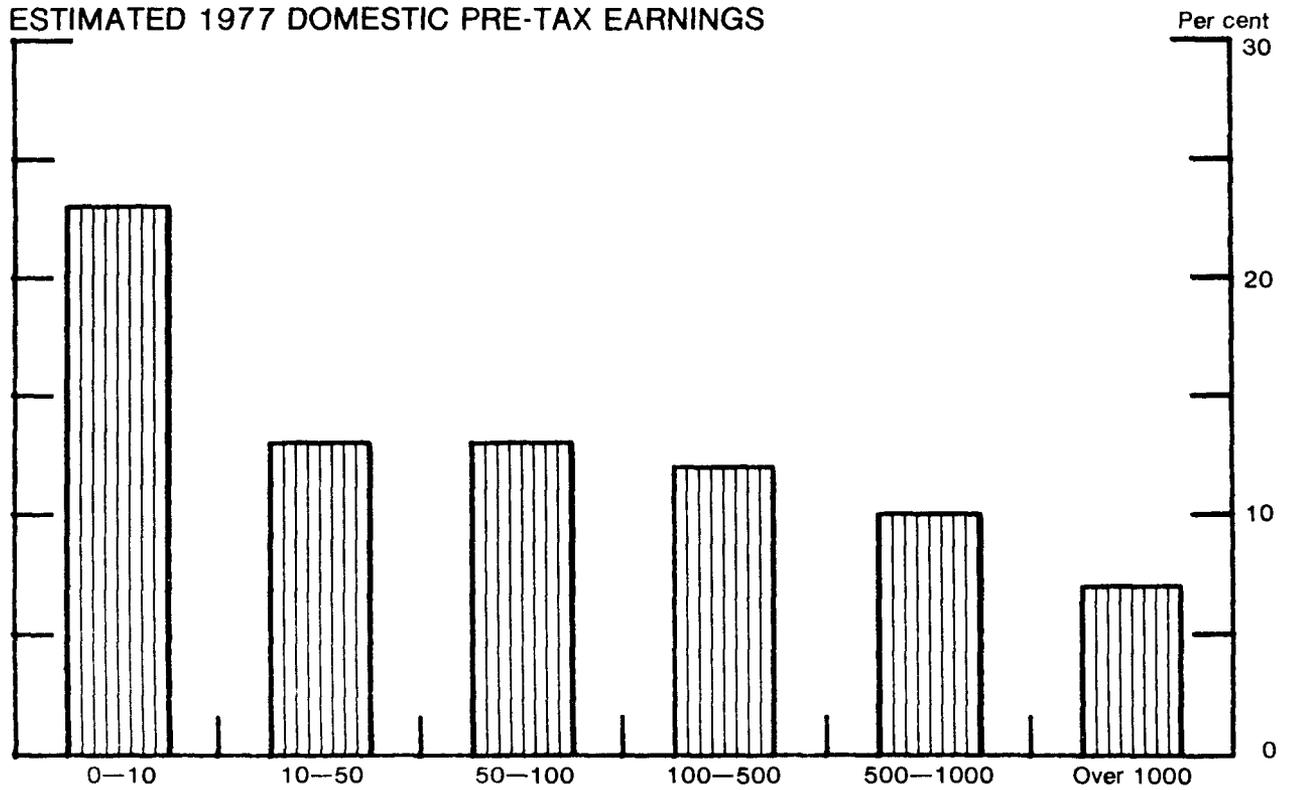


Estimated Burden of Federal Reserve Membership

AGGREGATE BURDEN



AGGREGATE BURDEN AS PERCENT OF ESTIMATED 1977 DOMESTIC PRE-TAX EARNINGS



Bank size class(total deposits, millions of dollars)

Chart VIII

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

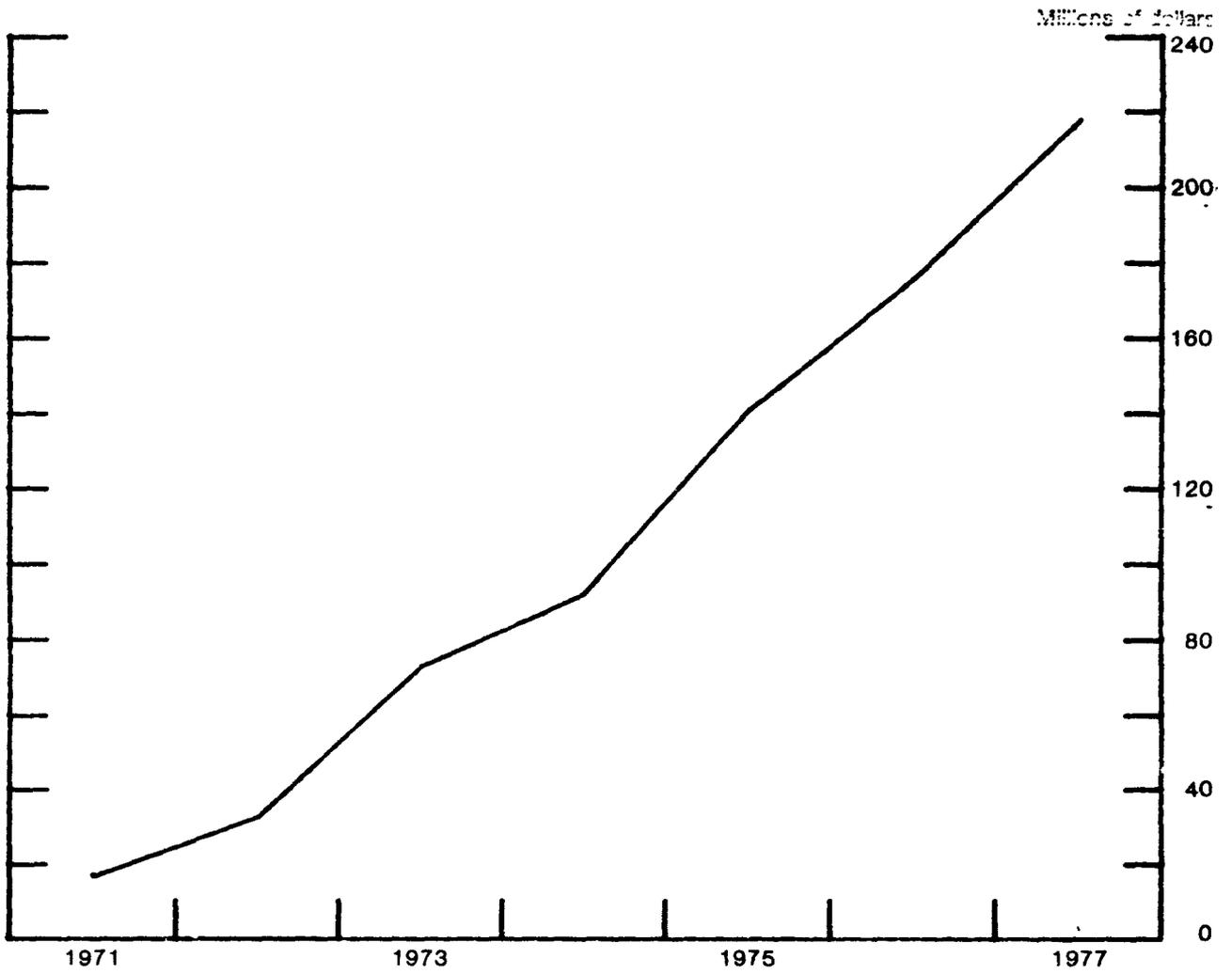


Chart IX

NOW Accounts as Percentage of Household Deposit Balances in New England

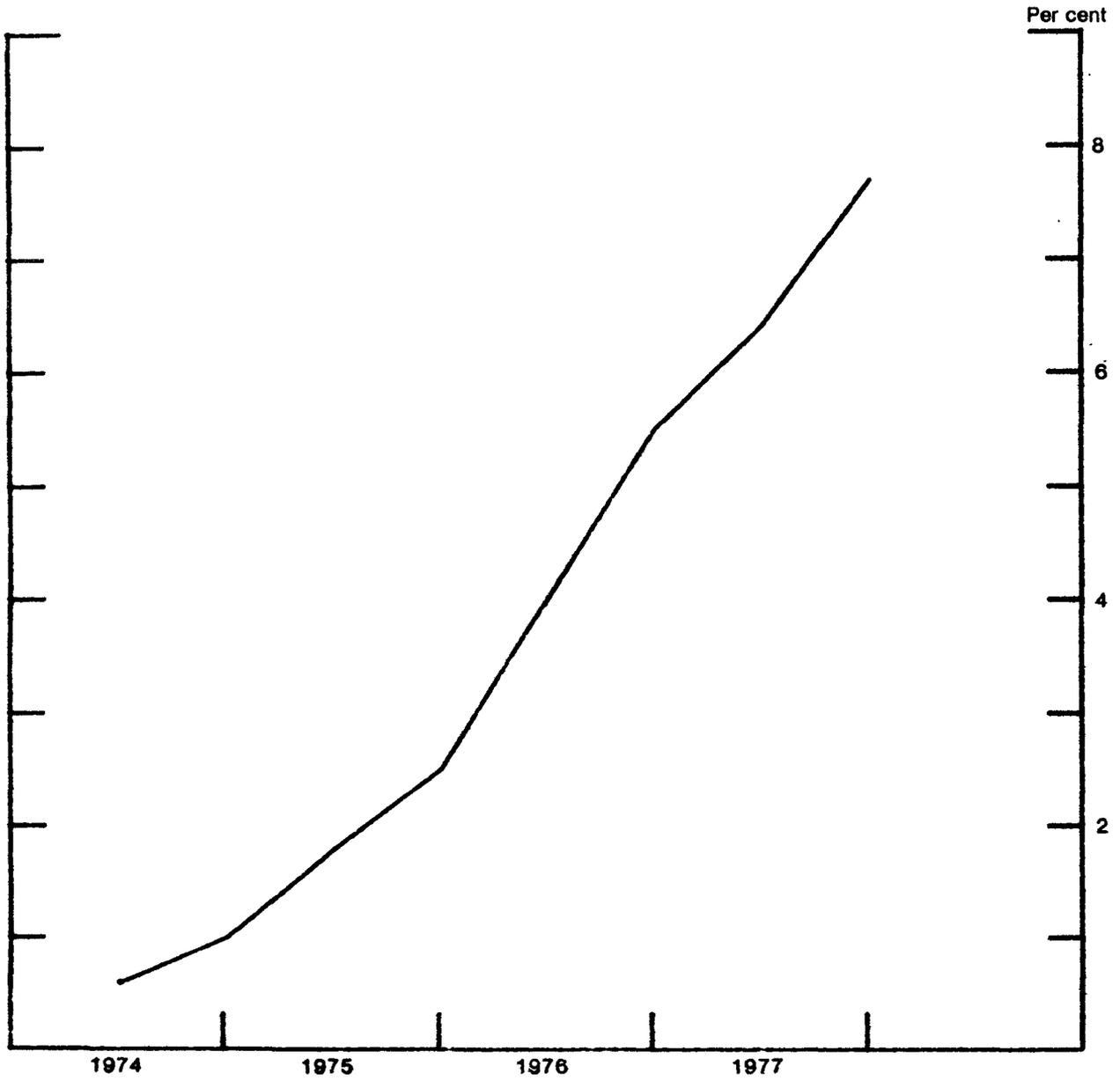


Chart X

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

Range of Unpredictable Variability

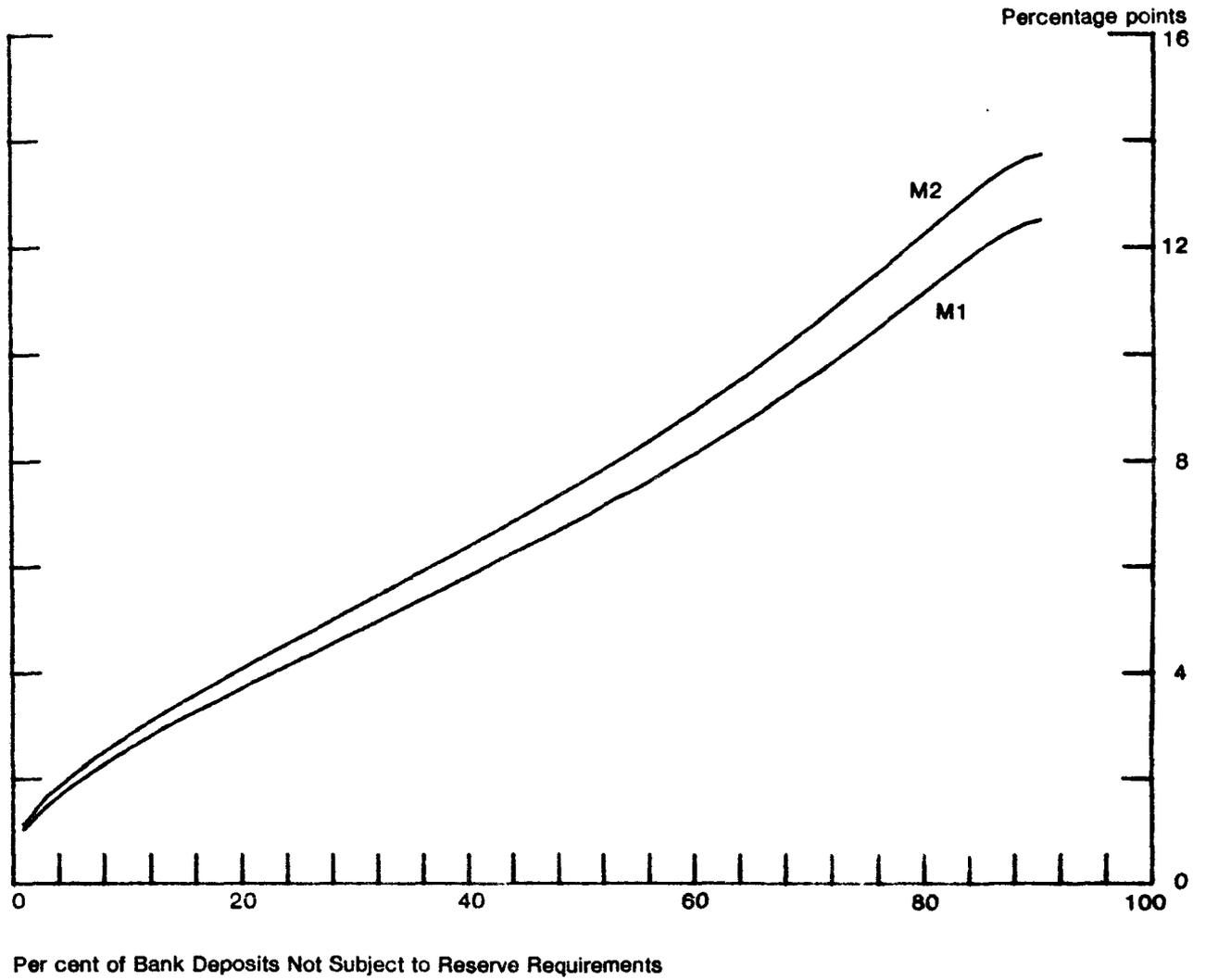


Chart XI

Estimated Loss of Treasury Revenues, Net of Taxes

