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

November 15, 1972

From Burns, on extending reserve requirements to all deposits subject to withdrawal
→ see tables & attached letter

The Honorable Herbert Stein, Chairman
Council of Economic Advisers
314 Executive Office Building
Washington, D. C.

Dear Mr. Chairman:

For several years the Board of Governors has sought Congressional approval of legislation which would make Federal Reserve reserve requirements applicable to all Federally insured banks, rather than to member banks alone. Last year, in its annual report, the Board stated its belief that reserve requirements should apply to all deposits subject to withdrawal by check in any type of financial institution.

These proposals are related to developments in Federal Reserve System membership over the past decade and to the evolution toward use of check-like transfer at nonbank savings institutions. Since 1960, 675 banks have left the System through withdrawal (including converting from national to State charters) and mergers. During the same period, 102 State-chartered banks voluntarily joined the System, while 1,483 newly State-chartered banks opted not to do so. Banks withdrawing in 1971 (41) averaged about $16 million in deposits, although there were several in the $20-$80 million range (Attachment 1). Thus far during 1972, three banks with deposits of $100 million or more have withdrawn, and most recently one bank -- the Wilmington Trust Company -- having deposits in excess of $500 million has withdrawn.

There is no great mystery about the reason why banks withdraw or remain outside the Federal Reserve System. There are some supervisory restrictions on members which may be significant in certain cases; but by far the most important reason for electing nonmember status is the difference in reserve requirements between member and nonmember banks and its effect on bank earnings. Virtually every State has reserve requirements which permit lower levels of non-earning assets for nonmembers and most States can and do reduce their requirements when the Federal Reserve does so. As banks strive for greater earnings, there is increasing incentive for them to withdraw from the System, and less incentive for new banks to join.

This change in Federal Reserve System membership has resulted in a declining proportion of deposits subject to Federal Reserve requirements. I attach a brief memorandum and tables tracing these changes over the past several years (Attachment 2). As the Annual Report of the Board of Governors for 1971 states, demand deposits held by any institution -- nonmember banks, savings banks, or any other -- are logically part of the country's

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Why

money supply, just as are those in member banks. Applying the same demand-deposit reserve requirements to all such institutions would facilitate the effective implementation of monetary policy. In lesser degree, the same might be said about time deposits. In fact, for monetary policy purposes, the distinction between demand and time deposits is being blurred, not only by the "Negotiable Order of Withdrawal" mentioned below, but also by new financial services which allow quick transfers from one type of deposit to another.

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The proposal to extend reserve requirements to others than commercial banks has become increasingly pertinent as savings banks, credit unions, and other institutions have sought and, in some cases, have obtained the right to engage in third-party transfers of funds. In the State of Massachusetts, for example, savings banks have instituted a controversial form of interest-bearing account subject to a "Negotiable Order of Withdrawal" -- an arrangement which is tantamount to a checking account. Issues of interest payment on demand deposits and competitive equity aside, this adds to the effective money supply outside the direct control of the monetary authority.

The Federal Reserve System, by administrative rule, recently restructured its reserve requirements for member banks in such a way that required reserves are a function of bank size alone, rather than ~~re~~location, and so that there is a smoother progression of requirements against increasing deposit-size categories. The System would be prepared to make other types of changes should nonmember banks and other financial institutions be subject to its reserve requirements, to the end that the transition to a new situation be smooth and that equity among institutions be improved.

Accompanying its recommendation on reserve requirements, the Board has proposed that the privilege of borrowing from Federal Reserve Banks be extended to all institutions subject to its reserve requirements. The Federal Reserve, as lender of last resort, must stand ready to make funds available in emergencies to the entire banking system regardless of membership status. As in the case of the recent changes in the payment mechanism, the Federal Reserve, in the public interest, cannot exclude nonmember institutions. Legislation is required to insure that this vital service is available in timely fashion to all depository institutions, and that all institutions share equitably in the System's costs.

The Board hopes that the Council of Economic Advisers will see fit, in its forthcoming report, to recommend legislation designed (1) to apply a flexible system of reserve requirements to the deposits of all depository institutions that accept deposits subject to transfer to third parties on demand and (2) to authorize the Reserve Banks to extend credit to such institutions on the same basis as they extend credit to member banks. The need for such legislation is of long standing, and it is becoming a matter of urgency. The future effectiveness of monetary policy, and of financial institutions as a whole, depend on it.

Sincerely yours,

Arthur F. Burns

Enclosures

cc: The Honorable George P. Shultz

Effects of Changes in System Membership on Deposits Subject to Reserve Requirements

Member bank demand deposits as a component of total money supply (M_1) have declined steadily from 65.4 per cent at the end of 1960 to 58.6 per cent at the end of 1971. During the same period, demand deposits in nonmember banks as a percentage of total money supply increased from 14.3 per cent to 18.6 per cent (Table 1).

Looking at a broader definition of money supply (M_3), member bank demand deposits declined from 23.3 per cent of the total in December 1965 to 19 per cent in December 1971 while the percentage of nonmember bank demand deposits remained practically unchanged. These movements reflected to some extent a shift in the form in which liquid assets are held, from demand to time deposits; member bank time and savings deposits as a percentage of total increased from 22.2 per cent to 24 per cent, nonmember time and savings deposits from 5.7 to 8.5 per cent. Deposits at nonbank thrift institutions remained relatively unchanged at 35 per cent, by far the largest component of M_3. In effect, virtually one-half of the money supply, as broadly defined, was outside the direct control of the monetary authorities at the end of 1971 (Table 2).

TABLE 1

Components as a Percentage of Total Money Supply - 1960-1971 1/

Last-month-of-year	Member bank demand deposits	Nonmember bank demand deposits	Currency and coin
1960	65.4	14.3	20.3
1961	65.4	14.5	20.1
1962	64.6	14.9	20.5
1963	63.7	15.3	21.0
1964	63.2	15.7	21.2
1965	62.3	16.2	21.4
1966	61.4	16.4	22.1
1967	61.6	16.6	21.8
1968	61.1	17.1	21.8
1969	59.7	17.9	22.4
1970	59.5	17.9	22.6
1971	58.6	18.6	22.8

1/ Based on last-month-of-year not seasonally adjusted data.

Attachment 1

BANK MEMBERSHIP STATUS

	Newly Formed Banks			Voluntarily Joining		Withdrawals		Merged Out of System	
	State Nonmember	State Member	National	State Members	National (Converted)	State Members	National (Converted)	State Member	National
1960	98	4	33	6	6	26	9	5	3
1961	84	2	24	5	5	17	1	2	6
1962	116	5	62	5	7	23	5	2	16
1963	133	3	163	5	15	22	16	4	8
1964	133	3	200	4	19	19	5	1	7
1965	106	4	88	1	13	22	7	4	10
1966	88	5	25	3	10	32	7	2	12
1967	81	3	18	1	7	21	5	3	11
1968	72	1	17	4	8	39	11	0	17
1969	111	6	17	2	8	42	27	7	11
1970	137	8	40	0	4	38	38	2	11
1971	155	9	37	4	7	20	21	1	11
1972*	169	7	36	2	10	27	11	3	5
	1,483	60	760	42	119	348	163	36	128

*Through September

TABLE 2

Components as a Percentage of M_3 -- 1965-1971*

December Average	M_3	Member Demand Dep. Comp. of M_1	Nonmember Demand Dep. Comp. of M_1	Currency and coin	Com'l Bank Time and Savings Deposits Other than Large CD's: Member Bank	Com'l Bank Time and Savings Deposits Other than Large CD's: Nonmember	Deposits of Nonbank Thrift Institutions
1965	100.0	23.3	6.0	8.0	22.2	5.7	34.8
1966	100.0	22.4	6.0	8.1	23.0	6.1	34.5
1967	100.0	21.8	5.9	7.7	23.7	6.5	34.4
1968	100.0	21.5	6.0	7.7	24.1	7.0	33.7
1969	100.0	21.1	6.3	7.9	23.3	7.4	34.0
1970	100.0	20.6	6.2	7.8	23.6	8.1	33.7
1971	100.0	19.0	6.1	7.4	24.0	8.5	35.0

* Detail may not add to total due to rounding.

CHAIRMAN OF THE BOARD OF GOVERNORS
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December 13, 1972

Dear Herb:

As I told you the other day, the Board continues to be deeply concerned about the attrition being experienced in System membership. An article in the New York Times of December 5 reported the withdrawal of two more large member banks--one in New Jersey and one in Maine--each of which had deposits in the neighborhood of $200 million.

Our internal statistics show that 51 banks have withdrawn from membership this year through mid-November, 10 more than in all of 1971. Most of these were small institutions, but several were in the class above $100 million. This continuing--and even accelerating--rate of withdrawal weakens the System and the basis for effective monetary control. It emphasizes the need for a prompt and equitable restructuring in the burden of reserve requirements, along the lines of the proposal set forth in my letter of November 15.

Sincerely yours,

Arthur F. Burns

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