FEDERAL RESERVE BANK OF NEW YORK

[Circular No. 8093
April 19, 1977]

To All Member Banks in the Second Federal Reserve District, and Others Concerned:

Over the past few years a significant number of banks have elected to withdraw from membership in the Federal Reserve System. Almost without exception, they have cited the high costs of maintaining required reserve balances with the Reserve Banks—costs which are well in excess of the cost of reserve requirements imposed by the banking laws of the various States on nonmember banks. These withdrawals, and the tendency for newly formed banks not to join the Federal Reserve, have resulted in a steady erosion of the percentage of deposits in the banking system subject to reserve requirements set by the central bank, and, therefore, in the portion of the money supply under the direct control of the monetary authority. The membership problem thus raises important concerns about the equitable regulatory treatment of competing depository institutions and the ability of the Federal Reserve to conduct monetary policy effectively.

In light of these considerations, the directors of the Federal Reserve Bank of New York requested the management of the Bank to review alternative approaches for dealing with the membership problem and to consider the related issue of developing an equitable basis for providing nonmember institutions with access to Federal Reserve services. In view of the important and complex nature of these issues, the directors suggested that an informal advisory committee of bankers be formed to assist in that effort.

During the course of the review, the Bank's management formulated a statement of principles to govern the form and scope of measures to deal with these problems. Those principles, together with the broad outlines of two alternatives for dealing with the membership problem, are set forth in a report that has been presented to the board of directors. The directors view the statement of principles as a sound framework upon which to build a program to stem the decline in membership. In the interest of fostering a better public understanding of the issues and criteria to be considered, the directors agreed that the report should be shared with member banks and other interested parties. Accordingly, there is enclosed for your use a copy of the text of the report which is entitled "The Problem of Membership: The Elements of a Solution."

Additional copies of this report will be furnished upon request.

FRANK R. MILLIKEN,
Chairman of the Board.

The Problem of Declining Membership: The Elements of a Solution

A Report to the Directors of the Federal Reserve Bank of New York

April 1977

The framers of the Federal Reserve Act did not believe that it was necessary for all commercial banks to become members of the Federal Reserve System. Nevertheless, the assumption underlying the creation of the nation's central banking system was that it would have the membership and support of banks holding a significant majority of bank deposits. In fact, membership in the Federal Reserve did grow rapidly and by the end of the first decade of the System's existence, about a third of the nation's commercial banks were members. These banks held almost three-quarters of the nation's total commercial bank deposits. By the end of World War II, the number of member banks was almost half the total of commercial banks and the volume of total bank deposits they held had reached 85 percent.

More recently, the experience has been quite different. The percentage of banks that are members and the percentage of the nation's deposits held by member banks have both declined. This erosion of membership has become a matter of increasing concern to the Federal Reserve which, as the nation's central bank, must be in a position to influence directly changes in a large percentage of commercial bank deposits. This report, therefore, is addressed to the problem of declining membership.

The present structure and form of System reserve requirements imposed on member banks constitutes a major burden on these banks and is primarily responsible for the increasing withdrawals from membership witnessed in recent years. These withdrawals, and the tendency for newly formed banks not to join the Federal Reserve, have resulted in an erosion of the percentage of deposits in the banking system subject to reserve requirements set by the central bank and, therefore, in the portion of the money supply under the direct control of the monetary authority. In a strongly competitive banking climate, these adverse trends are likely to accelerate.

Two recent developments have heightened concern over the membership problem. One is the increased demands being made on the Federal Reserve System to provide nonmember banks and thrift institutions with direct access to Federal Reserve services. To the extent nonmembers are provided such services directly, the attractiveness of Federal Reserve membership will be diminished further. The other consideration is the possibility that Congress will authorize a new form of interest-bearing transaction account on a nationwide basis. Should this occur, the membership problem will intensify as many banks will experience sharply higher operating expenses. With added downward pressure on bank earnings, the incentive for member banks to leave the Federal Reserve will grow stronger unless effective measures are taken to deal with the burden resulting from the reserve requirements of the central banking system. If not checked, the continuing withdrawal of banks from membership in the Federal Reserve System raises the prospect that the ability of the System to conduct monetary policy with full effectiveness will eventually be compromised.

The membership problem thus raises important concerns about the equitable regulatory treatment of competing depository institutions and the ability of the Federal Reserve to conduct monetary policy effectively. Another dimension of these concerns deals with the soundness and stability of the nation's banking system. To the extent that the membership base of the Federal Reserve is eroded, the stabilizing influence that the Federal Reserve's discount window affords to the banking system in unsettled periods is reduced.

In light of these considerations, the directors of the Federal Reserve Bank of New York requested the management of the Bank to review alternative approaches for dealing with the membership problem and suggested that an informal advisory committee of bankers in the Second District be formed to assist in that review.* In approaching the problem, the discussions

*The Informal Advisory Committee of bankers was composed of Charles A. Agemian, Chairman, Garden State National Bank; J. Wallace Ely, Chairman, Security New York State Corporation; Joseph F. Fahey, Jr., Chairman, The State National Bank of Connecticut; Newman E. Wait, Jr., President, The Adirondack Trust Company; James Whelden, President, Ballston Spa National Bank; Wayne G. Hansen, Senior Vice President, The Chase Manhattan Bank (National Association); and John Stadter, Senior Vice President, Morgan Guaranty Trust Company of New York.

focused on formulating a set of principles to govern the form and scope of measures intended to eliminate substantially the reserve burden of membership. These principles also were intended to establish an equitable basis for providing access to Federal Reserve services and to establish a sound regulatory framework for implementing NOW accounts nationwide. The management of the Federal Reserve Bank of New York is grateful to the advisory committee for its assistance in this effort, but stresses that the principles reflect the views and judgments of the management of the Bank. Those principles are set forth below, along with a discussion of two broad alternatives for dealing with the burden of membership.

Statement of Principles

(1) The present burden of required reserves on members of the Federal Reserve should be substantially eliminated at the earliest practicable time. Membership in the Federal Reserve should not involve a significant penalty on member bank earnings.

Member banks must hold required reserves in the form of vault cash or nonearning deposit balances at a Reserve Bank. As a result, membership in the Federal Reserve System entails a handicap in the form of downward pressure on earnings. In contrast, the banking laws of most States impose reserve requirements on commercial banks that are not only lower than those of the Federal Reserve, but are specified in a form that in many cases permits banks to earn a return on their reserve balances.

Accordingly, membership in the Federal Reserve involves a substantial cost in terms of pressure on earnings and places member banks at a competitive disadvantage with respect to nonmember banks. The exact penalty that member banks pay as a result of System reserve requirements is difficult to quantify, since there are many factors that influence the earnings of both member and nonmember institutions. Nonetheless, it seems clear that the balance of these factors is adverse for member banks, as evidenced by the steady attrition of membership.

The reserve burden can also be viewed, in effect, as a special indirect tax on banks, but only on those banks that are members of the Federal Reserve System. It seems doubtful in concept, from the standpoint of economic efficiency and equity, that banking institutions should be taxed in this singular manner. However, if, as a matter of public policy, it were to be considered appropriate for the banking industry to bear a special indirect tax, then the burden of such a tax should be borne by all banks.

(2) Any program to alleviate the reserve burden of membership must provide for the holding of required reserves in a form and at levels consistent with effective implementation of monetary policy, and should permit the System to change reserve requirement ratios as may be needed in the future without impairing competitive relationships.

A prime responsibility of the Federal Reserve System, and one that all financial institutions have a clear interest in, is the effective conduct of monetary policy. It is important that any steps taken to eliminate the reserve burden not impair the ability of the Federal Reserve to carry out this function. Specifically, the Federal Reserve must retain the ability to exercise effective influence over money and credit aggregates. The Federal Reserve exerts this influence primarily through its open market operations, by adding to, or withdrawing from, the cash reserves of the banking system. Through the mechanism of required reserves, changes in bank reserves are in turn translated in a generally predictable way into changes in money and credit aggregates, which then affect overall levels of economic activity.

The minimum level of required reserves necessary to lend stability to this relationship cannot be precisely determined. However, if banks were under no obligation to maintain a particular level of required reserves, or if those required reserves were less than each bank would normally hold in the absence of System reserve requirements, the relationship between Federal Reserve actions to increase or decrease the volume of bank reserves and resulting changes in money and credit aggregates would become more volatile, thus impairing the Federal Reserve's ability to meet its policy objectives. In sum, required reserves provide a lever for the conduct of monetary policy and reserve requirements are the fulcrum against which that lever operates.

It follows that required reserves generally must be in excess of desired holdings of cash assets and must be held directly or indirectly in the form of balances at a Reserve Bank, for it is the latter that is under Federal Reserve control. It is also important for the Federal Reserve to have the ability to change required reserve ratios in order to meet the objectives of monetary policy without affecting the competitive position of member banks.

(3) Reserve requirements applicable to new forms of payment accounts should apply uniformly to all depository institutions, and reserves maintained against these accounts should be in a form that is consistent with effective implementation of monetary policy.

Authorization of new forms of payment accounts on a nationwide basis would create a potential for deposits in these accounts to become a significant percentage of the nation's money supply. In the absence of comparable reserve requirements for all institutions accepting such deposits, nonmember institutions would be in a better position to attract these accounts, which would foster a further decline in the percentage of deposits held by member banks. Thus, were these deposits to be excluded from coverage under System reserve requirements, the effectiveness and precision with which monetary policy is implemented would be undermined just as with a loss of membership. Therefore, uniform application of reserve requirements to such accounts at all depository institutions offering them is desirable to ensure effective implementation of monetary policy. It is also appropriate from the standpoint of equitable regulatory treatment that reserve requirement regulations governing new types of payment accounts apply uniformly to competing institutions.*

(4) Once the reserve burden of membership is substantially eliminated, the Federal Reserve should provide services to members and nonmembers on the basis of explicit prices and in a manner that is consistent with the Federal Reserve's programs and commitments designed to foster the development of a more efficient payments mechanism.

Demands for direct access to Federal Reserve services can be expected to grow as a result of the increased volume of automated payments transactions and the expanded role of thrift institutions in providing payments services. Resolution of the membership problem would put the Federal Reserve in a position to provide services directly to all depository institutions on an equitable basis. While the need for equitable treatment does not, in itself, require levying charges for the use of Federal Reserve services, such an approach is desirable as it would enable the Federal Reserve to provide services on a basis consistent with an efficient allocation of the nation's resources, and to recover the cost of providing services to the private sector. It is possible, however, that, as a practical matter, measures eventually enacted to deal with the membership problem might not be fully effective and might leave a residual burden on member banks. In these circumstances, the Federal Reserve must retain sufficient flexibility to provide services to its members on a basis that recognizes this situation.

Methods of Implementation

Stated as they are, these principles leave open a number of important questions concerning the manner in which they might practically be implemented. This report does not attempt to address all these questions, since a full and fair consideration can only be undertaken within the framework of a legislative proposal dealing with the membership problem and related issues. It does, however, discuss two broad alternatives that have been identified as promising approaches. One is the direct payment of interest, at rates comparable to alternative uses of funds, on all or some portion of member banks' balances held as required reserves. The second is to permit holdings of U.S. Treasury securities to count toward a portion of required reserves. Either alternative could, and should, be accompanied by some adjustment in the present level and distribution of reserve requirements.

There is, of course, a third alternative, which is the extension of uniform reserve requirements to deposit liabilities of all competing depository institutions. This approach has much to recommend it from the standpoint of regulatory equity, since all competing institutions then would share in the burden imposed by reserve requirements, although it is likely that some problems would arise in defining exactly the full range of financial institutions that should be covered. Draft legislation incorporating this approach has been submitted by the Board of Governors to Congress in the past, but has not been received favorably. Such an approach would

*This point can also be made with respect to interest rate ceilings, but because the present distinction in that case is not based on membership, it is not inherently part of the membership question.

appear to remain highly controversial and, therefore, is unlikely to be adopted as a solution to the problem. Also, given the possibility that nationwide NOW accounts may soon be authorized, and the likely result of substantially higher operating expenses for depository institutions, the prospects for extending the present System reserve requirements on demand, time, and savings accounts to nonmember depository institutions seem highly doubtful.

While the principles set forth in this paper are not inconsistent with the concept of universal requirements, neither are they dependent upon it. They are fully consistent with retaining the concept of voluntary membership, while substantially eliminating the earnings burden imposed on member banks. A significant new burden would not be placed on nonmember institutions.

In considering the two alternatives specified above (payment of interest on the required reserve balances of member banks and counting holdings of U.S. Treasury securities as required reserves) certain observations are appropriate. Many bankers have expressed a preference for the second alternative as a way to avoid possible public controversy over the appropriate interest rate on reserve balances. While this concern merits consideration, a practical approach to the problem is an interest rate formula linked to market rates. With this approach, the direct payment of interest on reserve balances appears to hold greater potential for eliminating the reserve burden, without adverse implications for monetary policy.

Counting Governments toward a part of required reserves involves, in effect, reducing cash reserve requirements. The allowable percentage of Governments, therefore, would have to be confined to a range that would be consistent with the minimum levels of cash reserves needed for the effective implementation of monetary policy. Because only a limited fraction of current requirements might be placed in the form of securities, given the requirements of monetary policy, relief of the reserve burden would be inherently limited. Moreover, there is the danger that counting Governments toward required reserves might reasonably be considered as a form of credit allocation, becoming a precedent for extending such requirements to other forms of credit. The eventual result could be inconsistent with the philosophy of relying broadly on competitive market processes to determine the flow of credit.

Transitional Arrangements

Proposals considered to deal with the problem of declining membership will require legislation that may or may not be forthcoming, and then only after some significant delay. So long as the prospects for legislation are uncertain, member banks have pressed strongly for the Federal Reserve to consider actions it might take within its present authority to reduce the reserve burden on member banks. This would mean the largest practicable reduction of reserve requirements under present and prospective economic conditions. It is, of course, not possible to eliminate the entire reserve burden by this approach. Nonetheless, announcement of interim action by the Federal Reserve could lay the foundation for whatever more comprehensive measures may be forthcoming and would serve to demonstrate the System's concern over the severity of the membership problem and its commitment to resolving it.

Concluding Comments

The principles discussed in this paper focus primarily on the pressing and urgent problem of declining membership in the Federal Reserve System. They also have the important objectives of establishing a sound regulatory framework for introducing nationwide NOW accounts, if the Congress chooses to move in that direction, and developing an equitable, efficient basis for providing Federal Reserve services to financial institutions. These issues separately have important implications for the continued health of the nation's economy and financial system. The difficulties that have arisen in connection with resolving these issues are symptomatic of a broader problem that has for some time influenced the evolution of the nation's financial system — the unequal regulatory treatment of depository institutions that provide essentially the same services to the public. In addressing the urgent problem of Federal Reserve membership, the principles outlined in this report, if implemented, would be an important step in the direction of dealing with these inequities. A sound foundation would also be established for dealing with the remaining areas of concern.