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FEDERAL RESERVE REQUIREMENTS ACT OF 1978

MONDAY, AUGUST 14, 1978

U.S. Senate,
Committee on Banking, Housing, and Urban Affairs,
Washington, D.C.

The committee met at 10:05 a.m. in room 5302, Dirksen Senate Office Building, Senator William Proxmire, chairman of the committee, presiding.

Present: Senators Proxmire, Lugar, and Schmitt.

The Chairman. The committee will come to order.

Mr. Chairman.

Mr. Miller. Good morning, Mr. Chairman.

OPENING STATEMENT OF CHAIRMAN PROXMIRE

The Chairman. Today we begin 4 days of hearings on matters related to reserve requirements and affiliation with the Federal Reserve System. The bill before the committee is S. 3304. I introduced the measure by request of the Federal Reserve Board. There are also other bills on this same issue being considered by the House Banking Committee.

The legislation before us contains four parts:

1. The establishment of universal reserve requirements against transaction accounts of all depository institutions;

2. Restructuring of reserve requirements including establishment of reserves against transaction accounts with a range of 3 to 10 percent and reducing the lower limit of the reserve range against time and savings deposits to one-half percent from the present 3 percent;

3. The establishing of a rational pricing system for services currently provided free of charge by Federal Reserve banks; and

4. The congressional authorization of interest payment on reserves held at Federal Reserve banks.

The objectives of the legislation according to the Federal Reserve are to provide for greater competitive equality among financial institutions, to improve the conduct of monetary policy, to assure the safety and soundness of the banking system, and to promote a sound and efficient payments system.

The major thrust of the legislation is to find a solution to the Federal Reserve's loss of members. Therefore, it is incumbent on the committee to get answers to questions about the Federal Reserve's membership problem and to understand the implications for this problem for Federal Reserve policy. The membership problem has been an overbearing concern of the Federal Reserve for some time. I fear that the diversion of time devoted to this issue may be harmful to more important monetary matters.

(1)
It is difficult to believe that we should need to be concerned with membership in the Nation's central bank. The Federal Reserve is virtually alone among central banks throughout the world in its reliance on membership. In almost all other nations all banks must be related to the central bank at least for monetary control purposes and most of the time for clearing and settlement of payments. Why we should perpetuate the idea of "membership," as such, in the U.S. central bank rather than mandating some affiliation for all banks is a question that must be asked from the very start of these hearings. If mandatory universal reserve requirements can be established, the issues raised by the Federal Reserve would be solved once and for all and the Federal Reserve could get on with its important job of being a central bank to the Nation rather than a "members only" club.

I would like to make a few observations about each of the parts of S. 3304. The issues are not entirely new, but they are complex and many of them are technical.

First, I think universal reserves on transaction balances is needed and that we should work toward this basic change in order to blur the distinction between members and nonmembers. But it must be done in a fair manner and it must include a recognition of the costs of reserves, especially to small banks; it must include access to the discount window for all banks; and it must include access to the Federal Reserve's payments system for all depository institutions.

Second, since the cost of idle reserves and the complicated reserve structure has been emphasized by the Federal Reserve it is important to consider carefully both simplification and a reduction in required reserves. However, reducing required reserves will result in lower earnings to the Federal Reserve and thus will result in reduced revenue for the Treasury. The committee has an obligation to be mindful of the potential cost to the Treasury and the taxpayers of this country and to guard against an outright granting of funds to the banks. Reserve reductions need to be justified, especially the request made by the Federal Reserve to reduce the lower limit on the time and savings reserve range to 0.5 percent. That's a drastic reduction and it's one I think we ought to look at very carefully.

Third, on almost every basis the charging for Federal Reserve services at market-related prices makes good economic sense. It would provide for a more efficient payments system by clearly indicating costs and allocating services to users willing to pay. It would allow the private sector to compete with the Federal Reserve for payments service business. They cannot do that effectively now because of the zero prices set by the Federal Reserve and the monopoly that has been created. Pricing would also allow for a rational and fair access policy. Federal Reserve services are now basically available only to members. Open access to all depository institutions willing to pay should be sought.

Finally, the payment of interest on reserves must be examined with utmost care. There is no precedent for this in the history of the Federal Reserve and there is no authorization in the Federal Reserve Act or in its legislative history. I have opposed such interest payments before because even payment of a modest amount of interest would set a precedent that would be an invitation to larger and larger transfer of funds from the Treasury to the banks. I remain skeptical of the
need for such payments. It seems to me the Federal Reserve’s membership problem could be solved without cost to the Treasury simply by requiring all institutions to keep reserves at the Federal Reserve banks.

There are a lot of questions to be asked. I’d like to welcome you again, Chairman Miller. You have been an outspoken proponent of getting something done about Federal Reserve membership. At this point you must feel like the little Dutch boy holding his finger in the dike waiting for someone to hold back the floodwaters. You want Congress to stop the membership flood and have been determined in your effort. But, I must warn you that in another story Jason’s job was to guard the golden fleece. The Congress must protect the Treasury.

I hope that we can find a way to solve the membership problem without large cost to the Treasury and I hope we can do it quickly so you can get on with more pressing economic matters that are of substantial significance to the Nation.

Go right ahead, sir. I apologize for taking so long in this opening statement and I’m particularly aware of the irony of my asking you now if you can present your statement orally in about 10 minutes or so. The entire statement will be printed in full in the record, including the additional matter that you add at the end, the 13-page addendum and the 10 charts. I had a chance to study those carefully over the weekend and I was very impressed by your statement.

STATEMENT OF G. WILLIAM MILLER, CHAIRMAN, BOARD OF GOVERNORS, FEDERAL RESERVE BOARD

MR. MILLER. Thank you very much, Mr. Chairman.

I appreciate the opportunity to be here. Let me say that I am well aware of the difficulty of taking up legislation of this importance so late in a busy session, so I’m doubly grateful—to you and the committee for allowing the legislation to be considered, and to you for submitting the legislation for consideration at our request.

I know the issues are complex. Your introductory statement was helpful in outlining the fundamental issues. I hope that as we explore this question we do, in fact, address it in terms of the broader issues of equity and fair competition among financial institutions rather than consider the more narrow issue of membership. As you point out, membership in the central bank is not essential; it’s a rather unique concept in the United States in terms of the functioning of a central bank. And so it would be appropriate for us to think in broader terms.

I will briefly hit the highlights of my prepared testimony as you suggest. While you have already looked at the accompanying charts, I might just use them as a means of calling attention to certain points.

Whether we look at this as a broad issue or a narrow issue, the reason for urgency is that, with the attrition of membership, the central bank is, in fact, losing its influence over money and credits.

Chart I shows attrition in recent years. Over the last 8 years, 430 banks have left the System and 103 have joined. Most of the banks
that left the System some years ago were smaller banks, but more recently we have seen a tendency for larger banks to leave the System. We even hear rumbles about very substantial banks leaving. This is illustrated in chart II: From 1970 to 1977 the size of banks leaving the System has tended to become increasingly larger.

Chart III shows the result of this attrition on the percentage of commercial banks and commercial bank deposits in the Federal Reserve System. The slope of the deposits line is what is of concern to us, because if that decline continues for another 10 years the effectiveness of the central bank will be greatly lessened.

Chart IV makes a similar point but from a regional point of view. For a number of reasons, withdrawal from the System has been particularly dramatic in New England. Partly that is because of the competitive situation in New England: the NOW accounts have made it important for banks there to look carefully at all their cost burdens, and so there's been a particularly rapid attrition in New England as shown in chart IV. It wasn't long ago that New England had a larger percentage of commercial bank deposits in the Federal Reserve System than the Nation at large, but in 10 years, that percentage has gone to substantially below the national average, which shows how quickly withdrawals can accelerate.

Chart V shows what this membership issue is all about: it's about the burden of membership; it's about the cost of being a member. The fundamental issue is that members are required to maintain reserve balances with the Federal Reserve on which no earnings are realized—sterile balances. Nonmembers, on the other hand, generally are able, under State laws, to hold reserves either in the form of assets or deposits that would be held in the normal course of business. Chart V shows that members hold a higher percentage of assets in nonearning form than nonmembers, and it illustrates the competitive advantage that nonmembers have.

In terms of earnings and profitability of members compared to nonmembers, chart VI shows nonmembers on the top, with consistently higher earnings than members. This, again, illustrates the cost burden of membership.

Chart VII illustrates the estimated burden of Federal Reserve membership. The aggregate burden is plotted in the upper panel of that chart, which shows, by size of bank, the millions of dollars of burden. The lower panel shows the burden as a percent of pretax earnings: as a percent of earnings, the burden falls particularly heavily on smaller banks, which is why we have seen so many leaving the System.

Chart VIII shows the effect of the loss of membership in terms of the issue that you mentioned, Mr. Chairman—loss of revenues to the Treasury. Federal Reserve earnings are paid over to the Treasury and represent a source of revenue, similar to taxes, which belongs to the public. In chart VIII, we show the annual loss of Federal Reserve revenues as a result of attrition. The cumulative impact is such that if today, we had the same membership that we had back in the beginning of this decade, the earnings of the Federal Reserve would be $220 million higher. So the attrition we have already experienced has cost the Federal Reserve earnings of $220 million and as a result, cost the Treasury $100 million.
Chart IX shows that NOW accounts in New England have grown particularly rapidly, and this competitive pressure is one of the factors that has accelerated withdrawals in New England.

What does all this mean in terms beyond simply the desirability of membership in the central bank or of the central bank's encompassing a substantial share of the Nation's deposits? It affects, to a great extent, the financial system itself and the monetary controls that we might exercise. The declining trend in membership weakens the financial system in several ways. The testimony sets this issue out pretty thoroughly, and I would be happy to answer questions, about the effects on the financial system.

I would like to call your attention, though, to chart X, which illustrates one of the effects on monetary policy. This chart is particularly important because it shows the relationship between the percent of bank deposits not subject to reserve requirements and the predictability of the money supply. As you move to the right on this chart—as more and more deposits are not subject to Federal Reserve requirements—the predictability of the money supply is weakened, and this makes the operation of monetary policy very difficult. The more unpredictable the money aggregates, the more imperfect the fundamental data and the less control over the outcome of Federal Reserve policies. Better monetary policy can obviously be exercised when the predictability of our action is at a very high level for our proposal.

Rather than go through the various arguments which are spelled out in the testimony and which I think are well known to this committee, I would, again, just touch on the question of cost to the System. The proposal that we have submitted to you and that you have introduced at our request for paying interest on reserves, charging for services, and reducing reserve requirements, would be phased in to reduce impact on Treasury revenues.

Chart XI shows that, based on the assumption of continued attrition at the rate we have experienced nationally in recent years, there would be another $100 million loss to the Treasury by 1983. That is the cost of attrition. The cost of the Board's plan is about $300 million. So the true cost of the plan, using those assumptions, is probably about $200 million by 1983.

On the other hand, if attrition should accelerate to the level we have experienced in New England—which is the more likely occurrence in my opinion—then we can see that the loss to the Treasury from continued attrition would be over $250 million by 1983. The cost of the Board's plan, again, is about $300 million. In the absence of our program, we can expect an impact on Treasury revenues between $100 million and $250 million.

I would like to make one other comment on a point you made in your introductory statement. I would like to say that it seems to me the ideal solution would be to have universal reserves on transaction balances and, ideally, applied not only to banks but to all financial institutions. As financial institutions other than banks gain the right to handle transactions balances outside of the control of the central banking system, what is being created is a very inequitable system. Banks are handicapped in their ability to compete with other financial institutions, and member banks are handicapped more than other banks. So if we could agree on universal reserves, as you point out, that solution would be fair and it would provide broader access to the Federal Reserve so that it can operate as a central bank for the
nation rather than as a central bank for members. That solution would be very desirable.

We also concur with your suggestion that we seek to find a simplification in the formula for reduction of reserve requirements. Again, ideally, it would be well to work not only toward universal reserves, but toward more uniform reserves. Then there would be less reason for banks and other financial institutions to direct their energies toward choosing the form of deposits—toward avoiding requirements or finding deposits that require less reserves. We would instead have a system which, through its uniformity, allows institutions to opt for the best service to their customers.

I will end my comments here, Mr. Chairman. I appreciate your including this testimony in full in the record. I am prepared at this time—unless you would like some additional presentation—to proceed to questions.

[Complete statement of Chairman Miller and a copy of S. 3304, as introduced, follow:]
For release on delivery

Proposals on Financial Institution

Reserve Requirements and

Related Issues

Statement by

G. William Miller

Chairman, Board of Governors of the Federal Reserve System

before the

Committee on Banking, Housing and Urban Affairs

U. S. Senate

August 14, 1978
It is a pleasure to testify today on behalf of the Federal Reserve System on the bill before your Committee to promote competitive equity between member banks and other depository institutions and to 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 such 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, the character of their business, and their managerial resources, these banks have access to sources of funds and 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.

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
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, but we believe the general approach embodied in S. 3304, the Federal Reserve Requirements Act of 1978, is the most effective one under existing circumstances. That bill combines, with certain modifications, the two legislative proposals recommended by the Board for promoting competitive equality and stemming membership attrition. The proposals encompass universal reserve requirements on transactions accounts and enactment of a limitation on the Board's ability to pay interest on bank reserves held at Federal Reserve Banks. While the Board of
course supports the approach of S. 3304, a few minor modifications of the bill as introduced may be desirable.

UNIVERSAL RESERVE REQUIREMENTS

The Board believes that the universal reserve requirements provision of Title I of S. 3304 would reduce competitive inequality between banks and other institutions insofar as transactions accounts are concerned and would 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. Title I of S. 3304 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 enhancing the stability of the payments mechanism. But it should be stressed that, while providing for universal reserves on transactions accounts, S. 3304 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 could 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**

In addition to universal reserves, the Board's proposal to promote competitive equality and stem attrition of member banks 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 plans 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 RESERVE BALANCES

Title III of S. 3304 would authorize the Board to pay interest on reserves and would limit the amount of interest that can
be paid. The Board had suggested a limitation on interest paid, after deducting the total amount of charges imposed for services, of 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.) Title III retains the 7 per cent limitation but contains a provision—in subsection (A) of that title—whose intended effect appears unclear and could be interpreted to require that part of the interest paid must offset charges for services on a bank by bank basis. The Board believes that its proposed language—which imposes an over-all limitation on the total amount of interest that can be paid after deducting the total of service charges imposed—would be simpler and administratively more flexible.

Within the over-all 7 per cent limitation, the Board proposes to pay close to a market rate of interest on required reserve balances up to $25 million in size. On the basis of current conditions, the proposed rate would be ½ 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.

Title III as introduced would legislate 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. The proposed bill 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.

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

JOINING

WITHDRAWING

Number of banks

Chart II
Percentage of Banks Withdrawing from the Federal Reserve System
By Size of Bank

1970-72

1973-75

1976-77

Size class (total deposits, millions of dollars)
Chart III
Percentage of U.S. Commercial Banks and Deposits in the Federal Reserve System

Per cent

BANKS

DEPOSITS

Chart IV
Per cent

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


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

MEMBERS

NONMEMBERS

Chart XI
Profitability of Member and Nonmember Banks
Pre-Tax Profits as a Per Cent of Total Assets
Chart XII
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 XE
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

- Percentage points

Per cent of Bank Deposits Not Subject to Reserve Requirements
Chart II

Estimated Loss of Treasury Revenues, Net of Taxes

<table>
<thead>
<tr>
<th>Year</th>
<th>Millions of dollars</th>
</tr>
</thead>
<tbody>
<tr>
<td>1979</td>
<td>400</td>
</tr>
<tr>
<td>1981</td>
<td>350</td>
</tr>
<tr>
<td>1983</td>
<td>300</td>
</tr>
</tbody>
</table>

COST OF BOARD PLAN

COST OF ATTRITION
Based on New England Trend of Past 3 Years

COST OF ATTRITION
Based on National Trend of Past 3 Years

1979 1981 1983
BOARD OF GOVERNORS OF THE
FEDERAL RESERVE SYSTEM

PRELIMINARY PROPOSAL

To Promote Competitive Equality Among
Member Banks and Other Financial Institutions
and to Encourage Membership in the Federal Reserve System

The continuing decline of bank membership in the Federal Reserve System and the increasing competition between banks and other depository institutions in providing payments services require prompt, responsive measures.

This preliminary proposal is intended as a means of submitting a program for consideration and appropriate action by Congress.

Background of the Problem

Section 19 of the Federal Reserve Act provides that member banks of the Federal Reserve System are required to maintain reserves against their demand and time deposits in such ratios as shall be determined by the Board within specified legal ranges. In order to satisfy these reserve requirements, member banks are required to maintain reserves in the form of vault cash and balances held in Federal Reserve Banks. Such balances maintained by member banks do not earn any interest at present. By contrast, most banks that are not members of the Federal Reserve System are permitted by State law to hold a substantial part of their required reserves in the form of earning assets, such as United States Treasury obligations, or in the form of balances that would be held in the ordinary course of business in any event. Consequently,
member banks incur a burden in the form of foregone earnings on their required reserve balances.

As a result of the inflation of recent years and the increased competition between banks and other depository institutions in providing payments services, more and more banks have become aware of the burden of membership and have determined that the benefits associated with remaining a member bank do not outweigh the costs. Over the past ten years, a total of 551 banks have withdrawn from membership. Although many of the banks that have left the System are small, there is a growing trend among larger member banks to become nonmembers. Of the 69 banks that left the Federal Reserve in 1977, 15 banks possessed deposits in excess of $100 million. Because of the decline in membership, the proportion of total commercial bank deposits held by member banks has by now been reduced to about 72 per cent.

If corrective action is not taken, a continued, probably an accelerated, erosion of membership and of deposits subject to regulation by the Federal Reserve can be expected. This threatens to weaken the nation’s financial system, as more and more of the nation’s payments and credit transactions are handled outside the safe channels of the Federal Reserve, as fewer and fewer banks have immediate access to Federal Reserve Bank credit facilities, as a national presence in bank supervisory and regulatory functions becomes increasingly diluted, and as implementation of monetary policy becomes more difficult.
Proposed Legislation for Universal Reserve Requirements

In order to promote fair competition among member banks and other depository institutions and to stem the decline in deposits subject to reserve requirements of the Federal Reserve, the Board will transmit to Congress proposed legislation that would require all depository institutions to maintain reserves against transactions accounts in accordance with requirements set by the Federal Reserve. If uniform, universal reserve requirements on transactions balances become effective, competition among banks and other depository institutions would be on a more nearly equal basis.

The Board's proposed legislation would make transactions accounts—such as demand deposits and NOW (negotiable order of withdrawal) accounts—at all Federally insured depository institutions subject to reserve requirements set by the Federal Reserve. However, a total of $5 million of transactions accounts at these institutions, whether members or nonmembers of the Federal Reserve, would not be subject to the basic reserve requirements. The proposed legislation also adjusts the existing 3 to 10 per cent statutory range for reserve ratios on time and savings deposits at member banks. A reduction in the range to 1/2 of 1 to 10 per cent is proposed for time and savings deposits other than transactions accounts to provide needed flexibility that would enable member banks to compete in this area on a more nearly equal basis with other depository institutions.
The Board simultaneously is considering a program, described below, whereby the Federal Reserve would charge for certain of its services and would pay some compensation for required reserve balances. However, if Congress enacts a requirement for universal reserves, the Board would need to reconsider whether, and to what extent, its proposed program of service charges and reserve compensation might need to be adjusted in light of the effects of such legislation on Federal Reserve membership, operation of the payments system, and monetary control.

Proposed Federal Reserve Program

In view of the increasingly acute problems associated with the decline in membership in the Federal Reserve System that is attributable to the burden imposed on member banks by competitive inequality, the Board is also considering a program with the following principal elements: (1) restructuring and reduction of demand deposit reserve requirements, (2) charging for services provided by the Federal Reserve, (3) compensating for required reserve balances held at Federal Reserve Banks, and (4) transferring part of Federal Reserve surplus to Treasury during a transition period to offset any Treasury revenue loss.

The program would provide time for Congress to consider the issue of payment of interest on required reserve balances. If the Federal Reserve is not able to pay interest on reserves, or otherwise remove the burden of membership, it would not be feasible
to charge for services offered by Federal Reserve Banks. A portion of reserve balances held by member banks with Federal Reserve Banks in effect represents payment for these services under current circumstances. Charging for the services, without compensating banks for the reserves held, would simply increase the burden of membership and exacerbate competitive inequality.

**Reserve Requirement Actions.** Under the proposed program, the Board would amend Regulation D (Reserves of Member Banks) to simplify the structure of reserve requirements. The proposal would also redefine a reserve city and impose reserve city reserve requirements on member banks with net demand deposits in excess of $600 million (compared to $400 million at present). The structure of reserve requirements would be revised in two phases as follows:

<table>
<thead>
<tr>
<th>Present</th>
<th>Proposed</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>First phase</td>
</tr>
<tr>
<td>Size Class</td>
<td>Reserve Size Class</td>
</tr>
<tr>
<td>($ million)</td>
<td>Requirement ($ million)</td>
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<tr>
<td>0-2</td>
<td>7%</td>
</tr>
<tr>
<td>2-10</td>
<td>9½%</td>
</tr>
<tr>
<td>10-100</td>
<td>11½%</td>
</tr>
<tr>
<td>100-400</td>
<td>12½%</td>
</tr>
<tr>
<td>over 400</td>
<td>16½%</td>
</tr>
</tbody>
</table>

It is anticipated that these actions would have the effect of releasing approximately $5 billion in reserves on an annual basis, with about $2½ billion released by the initial adjustment.
Charges for Federal Reserve Services. The second element in the program relates to charging for services rendered by the Federal Reserve. The Federal Reserve does not now generally charge member banks for services it renders in view of the substantial burden of membership presently incurred by banks. Member banks "pay" for Federal Reserve services through the maintenance of reserve balances with Reserve Banks. Nonmember banks are now permitted to use a limited number of Federal Reserve services at no charge.

Competitive equity between member banks and nonmember institutions requires that all users of Federal Reserve services be subject to charges established on the same basis. Moreover, such charges might encourage more efficient use of check clearing facilities and provide incentives for innovations that reduce costs. With explicit pricing, therefore, the opportunities of the private sector to compete with and improve upon Federal Reserve services would be enhanced.

In order to assure continued efficient functioning of the payments mechanism and to avoid major disruption during the transition to a more competitive environment, the Board would follow a conservative and flexible approach in establishing charges for Federal Reserve services. To this end, the System has concluded that its charges should be competitive with those for comparable services (when available) in the private sector. However, the Board would retain flexibility to alter charges or service policies in order to meet its responsibilities to maintain a satisfactory, basic level of service for the nation as a whole and to encourage innovations.
The Board would use the following general principles as guidelines for establishing a price structure:

1. Each Federal Reserve service category for which charges are to be assessed would usually have separate prices by geographic area, activity, and class of work processed. The price schedule would employ explicit per item charges and be as simple as possible. Prices would be adjusted as the System gained experience with service charges and observed their effects in the markets in which the System operates.

2. The System does not contemplate significant alterations in services provided at the time charges initially are imposed. However, after charges are in place, some offices might find it necessary to revise their operating policies and prices to maintain competitiveness and to enable the System to maintain a basic level of service nationwide.

3. All users in the same pricing zone (typically a Federal Reserve Bank, Branch or office area) would pay the same price for a given service. However, identical services might not be provided in all areas.

More specifically, guidelines established by the Board for the pricing of Federal Reserve check and automated clearing house (ACH) services would include the following:

a. Charges for check services would be imposed on depositing institutions.
b. Prices for interoffice items deposited locally might include both a local processing charge and a uniform national charge.

c. Charges for automated clearing house (ACH) items could either be imposed on ACH associations or directly on financial institutions using the service.

d. Prices for automated clearing house services would be set to encourage the use of such services and to reflect mature volume levels.

It is anticipated that schedules of charges for System services would be announced for public comments, and implemented in two phases:

First phase: Charges for Federal Reserve payments services, including check processing, check transportation, and automated clearing house services.

Second phase: Charges for certain other services, including shipping of coin and currency to member banks, transfer and settlement of reserve balances, and purchase, sale, safekeeping and clearing of securities.

Based on the present volume of Federal Reserve Bank activity, and on the direct and indirect costs incurred by the System, it is estimated that charges imposed for System services would result in revenue to the Federal Reserve of approximately $225 million annually in the first phase and about $410 million annually thereafter. The
Federal Reserve does not anticipate imposing charges for governmental-type functions it performs, such as conducting bank examinations and monetary policy and certain activities associated with issuance and destruction of Federal Reserve notes.

Access to Federal Reserve Facilities. At present, Federal Reserve Banks maintain virtually no accounts for nonmember depository institutions. However, nonmember institutions may have access to Federal Reserve operated automated clearinghouse facilities (ACH's). Nonmember commercial banks may also deposit intra-regional checks and drafts at Federal Reserve regional check processing centers (RCPC's). When charges are imposed for payments services under the proposed program, the Federal Reserve would permit all nonmember depository institutions with third party payment powers to deposit intra-regional checks and drafts at RCPC's. Nonmembers would pay the same charges as member banks for services rendered by the Federal Reserve, and would continue to be required to settle through reserve accounts of member banks.

Once the proposed program has been fully implemented, and the Federal Reserve has evaluated the impact of the program on membership and on the functioning of the payments mechanism, the System expects to provide direct and full access for nonmember depository institutions to payments and other operational services provided by Federal Reserve Banks. Access would be provided on the basis of equality of treatment with respect to balances held by members and nonmembers; balances held by nonmembers would be equivalent to the
reserves of members and such funds would receive similar compensation.

**Compensation for Maintenance of Required Reserves.** The third element in the Federal Reserve's proposed program relates to compensating member banks for the maintenance of required reserve balances with the Federal Reserve. Member banks are at a clear competitive disadvantage because nonmember banks generally may satisfy reserve requirements by holding interest-bearing assets or balances that would be held in the ordinary course of business in any event, and this disadvantage contributes substantially to the erosion of membership. In order to reduce this inequality and to prevent further erosion in membership, the Federal Reserve believes it would be appropriate to compensate member banks by paying interest on required reserve balances. However, in no case would the amount of compensation paid to member banks after deducting service charges collected exceed 7 per cent of the net earnings of Reserve Banks (before payment of compensation). The Board will submit to Congress proposed legislation to formalize this limitation on the bank payment of interest on required reserve balances.

The Board proposes to phase in the payment of interest on required reserve balances of member banks concurrent with the imposition of charges for System services in accordance with the following schedule:
First phase: Payment of interest on all required reserve balances maintained at Federal Reserve Banks at a rate of 2 per cent per annum.

Second phase: Rate of interest payable would be increased to ½ percentage point below the average return on the Federal Reserve System portfolio, valued at book, for the first $25 million of required reserve balances at Federal Reserve Banks. Based on the 1977 return on the Federal Reserve portfolio, the rate of compensation on those balances would be 6 per cent per annum. The rate of interest payable on required balances held at Federal Reserve Banks in excess of $25 million would be 2 per cent per annum.

The Board estimates that interest payments to member banks would amount to about $430 million in the first phase and about $765 million annually thereafter, based on the current level of member bank deposits.

Effect on Treasury Revenues. Since 1947, the Federal Reserve has paid almost all of its net earnings to the United States Treasury. A portion of these earnings are attributable to the non-interest earning required reserve balances that member banks hold at Federal Reserve Banks. Nonmember institutions do not hold such balances and thus their reserve holdings are not a source of Treasury revenue. The program being proposed by the Board would substantially reduce this
unequal "tax" borne by member banks. At the same time the Board recognizes the budgetary need to maintain Treasury revenues.

The Board estimates that adoption of the proposed program, in the absence of universal reserve requirements, would in itself result in a cumulative net reduction in United States Treasury revenues on the order of $575 million over a transition period of, for example, about three years, until the program would be fully in place. To eliminate this anticipated loss of revenue during the transition period, the Federal Reserve would transfer an equivalent amount of its surplus to the Treasury. The Federal Reserve's program, therefore, would not result in any net reduction in the level of revenues received by the Treasury during the implementation period.

With the program fully in place, the net cost to the Treasury would be expected to be minimal, if there were any cost at all. Although Treasury revenues would be reduced by about $300 million per year as a consequence of the actions in this program, there would have been, in any case, a substantial decline of Treasury revenues in the absence of the program. At a minimum, if attrition in deposits subject to Federal Reserve reserve requirements continued over the next four years at the average rate of the recent past, Treasury revenues would be reduced by about $80 million in the fourth year and would increase further thereafter. If the rate of attrition were at the more rapid pace experienced in New England in recent years, the loss in Treasury revenues would be about $200 million by the fourth year. The program could be expected to reduce, if not
eliminate, such attrition in deposits. There might even be a gain in Treasury revenues if the program succeeds in increasing membership. The gain in revenues would be more pronounced if Congress enacted the Board's proposed universal reserve requirement legislation.

Result of the Proposal

The Board believes that implementation of the program presented in this statement is essential to the continued maintenance of a sound financial system. Implementation of its various elements should result in an environment in which financial institutions can compete on a more equitable basis, should arrest the decline of bank membership in the Federal Reserve System, and should facilitate the implementation of monetary policy.
A BILL To amend the Federal Reserve Act to provide for the maintenance of reserves for certain institutions; to require the imposition of charges for certain services by Federal Reserve banks; to authorize the payment of interest on reserves held in Federal Reserve banks; and for other purposes

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That this Act may be cited as the "Federal Reserve Requirements Act of 1978".

TITLE I—RESERVE REQUIREMENTS OF MEMBER BANKS AND OTHER DEPOSITORY INSTITUTIONS

SEC. 101. The first section of the Federal Reserve Act, as amended (12 U.S.C. 221), is amended by adding at the end thereof the following new paragraphs:

"The term 'depository institution' means—

"(1) any insured bank as defined in section 3 of the Federal Deposit Insurance Act;

"(2) any mutual savings bank as defined in section 3 of the Federal Deposit Insurance Act;

"(3) any savings bank as defined in section 3 of the Federal Deposit Insurance Act;

"(4) any insured credit union as defined in section 101 of the Federal Credit Union Act;

"(5) any member as defined in section 2 of the Federal Home Loan Bank Act;

"(6) any insured institution as defined in section 401 of the National Housing Act; and

"(7) for the purpose of section 13 and the fourteenth paragraph of section 16, any association or entity which is wholly owned by or which consists only of institutions referred to in clauses (1) through (6)."

"The term 'transaction account' means a deposit or account on which the depositor or account holder is allowed to make withdrawals by negotiable or transferable instrument or other similar item for the purpose of making payments to third persons or others. Such term includes demand deposit, negotiable order of withdrawal, and share draft accounts."

SEC. 102. Section 19(a) of the Federal Reserve Act, as amended (12 U.S.C. 461), is amended by adding at the end thereof the following: "In order to prevent evasions of the reserve requirements imposed by this Act, after consultation with the Board of Directors of the Federal Deposit Insurance Corporation, the Federal Home Loan Bank Board, and the Administrator of the National Credit Union Administration, the Board of Governors of the Federal Reserve System is further authorized to determine, by regulation or order, that an account or deposit is a transaction account where such account or deposit may be used to provide funds directly or indirectly for the purpose of making payments or transfers to third persons or others."

SEC. 103. The last sentence of subsection (b) of section 19 of the Federal Reserve Act, as amended (12 U.S.C. 461), is designated as paragraph (7) and that part of subsection (b) that precedes that sentence is amended to read as follows:

"(b) (1) Except as provided in paragraph (4), every depository institution as defined in section 1 of the Federal Reserve Act, as amended (12 U.S.C. 221), shall maintain reserves against its demand deposits at such average ratio of not less than 7 per centum nor more than 22 per centum, as shall be determined by the Board.

"(2) Except as provided in paragraph (4), every depository institution as defined in section 1 of the Federal Reserve Act, as amended (12 U.S.C. 221), shall maintain reserves which shall be at the same level for all depository institutions against all other transaction accounts at such average ratio of not less than 3 per centum nor more than 12 per centum, as shall be determined by the Board.

"(3) Every member bank shall maintain reserves against its time deposits and savings deposits (other than negotiable order of withdrawal accounts) at such average ratio of not less than one-half of 1 per centum nor more than 10 per centum, as shall be determined by the Board.

"(4) A total of $5,000,000 of transaction accounts of a depository institution shall not be subject to the reserve requirements of this section, subject to such rules and regulations as may be adopted by the Board. However, the Board
may impose reserve requirements on such transaction accounts at such average ratio of up to 7 per centum if determined to be appropriate in light of general liquidity, considerations of monetary policy, or other relevant conditions prevailing in the banking system.

“(5) Every depository institution as defined in section 1 of the Federal Reserve Act (12 U.S.C. 221) shall make reports concerning its deposit liabilities and required reserves at such times and in such manner and form as the Board may require.

“(6) (a) For purposes of determining the reserve requirements of a depository institution established after June 30, 1978, which is an affiliate of a depository institution subject to the reserve requirements of this section, the transaction accounts of such newly established depository institutions shall be added to the total transaction accounts of such affiliated depository institution.

“(b) In addition to its authority under section 19(a), the Board is authorized to determine, by regulation or order, the affiliated depository institution to whose transaction accounts the transaction accounts of a depository institution established after June 30, 1978, shall be added for purposes of this provision.”.

Sec. 104. With respect to any depository institution that is not a member of the Federal Reserve System on June 30, 1978, the required reserves imposed pursuant to subsection (a) against its transaction accounts on the effective date of this Act shall be reduced by 75 per centum during the first year that begins after the effective date, 50 per centum during the second year, and 25 per centum during the third year.

Sec. 105. (a) Section 19(c) of the Federal Reserve Act, as amended (12 U.S.C. 461), is amended to read as follows: “Reserves held by any depository institution to meet the requirements imposed pursuant to subsection (b) of this section shall be in the form of—

“(1) balances maintained for such purposes by such depository institution in the Federal Reserve bank of which it is a member or at which it maintains an account. However, the Board may, by regulation or order, permit depository institutions to maintain all or a portion of their required reserves against their transaction accounts in the form of vault cash: Provided, That such proportion shall be identical for all depository institutions; and

“(2) balances maintained by a nonmember depository institution in a member bank or in a Federal home loan bank maintains such funds in the form of balances in a Federal Reserve bank of which it is a member or at which it maintains an account. Balances received by a member bank from another depository institution that are used to satisfy the reserve requirements imposed on such depository institution by this section shall not be subject to the reserve requirements of this section imposed on such member bank and shall not be subject to assessment imposed on such member bank pursuant to section 7 of the Federal Deposit Insurance Act, as amended (12 U.S.C. 1817).”.

(b) Section 19(f) of such Act, as amended (12 U.S.C. 484), is amended by deleting “member bank” and inserting in lieu thereof “depository institution”.

Sec. 106. (a) The Federal Reserve Act is amended by inserting after section 11 (12 U.S.C. 248) the following new section:

“Sec. 11A. (a) Not later than July 1, 1979, the Board of Governors shall have prepared and shall publish for public comment a set of pricing principles and a proposed schedule of fees for Federal Reserve System services; and not later than July 1, 1980, the Board shall put into effect a schedule of fees for such services which is based on those principles. Except that the Board may put into effect fees for some of such services prior to July 1, 1980, but after July 1, 1979, if it determines such action to be appropriate.

**TITLE II—CONFORMING AMENDMENTS AND EFFECTIVE DATE**

Sec. 201. Section 5A of the Federal Home Loan Bank Act, as amended (12 U.S.C. 1425a), is amended by redesignating subsection (f) as subsection (g) and by inserting before such subsection, as redesignated, the following new subsection:

“(f) Every institution which is a member or an insured institution as defined in section 401(a) of title IV of the National Housing Act (12 U.S.C. 1724(a)) shall maintain reserves against its transaction accounts as defined in section 1 of the Federal Reserve Act (12 U.S.C. 221) in accordance with the provisions of section 19 of the Federal Reserve Act (12 U.S.C. 461) in amounts not less than such percentages of its aggregate amounts of such deposits or accounts as may be
prescribed under section 19(b) of the Federal Reserve Act (12 U.S.C. 461) by the Board of Governors of the Federal Reserve System."

Sec. 202. Section 116 of the Federal Credit Union Act, as amended (12 U.S.C. 1762), is amended by adding at the end thereof the following new subsection:

"(c) Each insured credit union shall maintain reserves against its transaction accounts as defined in section 1 of the Federal Reserve Act (12 U.S.C. 221) in accordance with the provisions of section 19 of the Federal Reserve Act (12 U.S.C. 461) in amounts not less than such percentages of its aggregate amounts of such deposits or accounts as may be prescribed under section 19 (b) of the Federal Reserve Act (12 U.S.C. 461) by the Board of Governors of the Federal Reserve System."

Sec. 203. (a) The first paragraph of section 13 of the Federal Reserve Act (12 U.S.C. 342) is amended as follows:

(1) by inserting after the words "member banks" the words "or other depository institutions";
(2) by inserting after the words "payable upon presentation" the first and third times they appear, the words "or other items, including negotiable orders of withdrawal or share drafts";
(3) by inserting after the words "payable upon presentation within its district," the words "or other items, including negotiable orders of withdrawal or share drafts";
(4) by inserting after the words "nonmember bank or trust company," wherever they appear the words "or other depository institution";
(5) by striking the words "sufficient to offset the items in transit held for its account by the Federal Reserve bank" and inserting in lieu thereof the words "in such amount as the Board determines taking into account items in transit, services provided by the Federal Reserve bank, and other factors as the Board may deem appropriate"; and
(6) by inserting after the words "nonmember bank" after the second colon the words "or other depository institution".

(b) The thirteenth paragraph of section 16 of the Federal Reserve Act (12 U.S.C. 360) is amended as follows:

(1) by striking out the words "member banks" wherever they appear and inserting in lieu thereof "depository institutions";
(2) by striking out the words "member bank" wherever they appear and inserting in lieu thereof "depository institution"; and
(3) by inserting after "checks" wherever it appears the words "and other items, including negotiable orders of withdrawal and share drafts".

(c) The fourteenth paragraph of section 16 of the Federal Reserve Act (12 U.S.C. 248(o)) is amended by striking out "its member banks" and inserting in lieu thereof "depository institutions".

Sec. 204. The provisions of this Act shall become effective one year after the date of enactment.

Title III—Authority for Payment of Interest on Reserves

Sec. 301. Section 13 of the Federal Reserve Act is amended by adding at the end thereof the following new paragraph:

"Subject to such limitations, restrictions, and regulations as the Board of Governors may prescribe, the Federal Reserve banks are hereby authorized to pay interest on balances held in any Federal Reserve bank pursuant to section 19(b) of this Act. The total amount of such interest paid with respect to any year shall not exceed the sum of the following items computed with respect to the same year:

"(A) total receipts by Federal Reserve banks from the recipients of such interest for services rendered to such recipients by such banks, and
"(B) 7 per centum of the total net earnings of the Federal Reserve banks computed without regard to the payment of such interest.

The rate of interest paid under this section shall not exceed 2 per centum per annum with respect to required balance in excess of $25,000,000 held at Federal Reserve banks."

The Chairman. That's fine. I want to thank you very much for a masterful summary of a complicated presentation. I very much appreciate it. Also the note on which you ended is most congenial.
I agree with you wholeheartedly that mandatory reserves for all but smaller depository institutions makes sense. Incidentally, I have here a letter from Secretary of the Treasury Blumenthal to the House Banking Committee chairman who says, in part,

The Treasury believes that the requirement of mandatory reserves for all but small depository institutions is the preferable method of dealing with that problem.

Now, universal reserve requirements have been proposed before sometimes with membership required and other times without mandatory membership. Your proposal is just for universal reserve requirements without membership. Why? Does this mean membership is not essential to the Federal Reserve operations but universal reserves are?

Mr. Miller. Senator, what we are seeking is equity in financial competition among financial institutions. We are aware that, in seeking that goal, there is no reason for the Federal Reserve to preempt or monopolize the process of bank examination or supervision which is now handled by a dual banking structure.

We were trying to preserve the dual banking system and, at the same time, to look at the problem from the point of view of both fairness in competition and the better monetary control that would result from greater control over deposits. Membership, per se, is not an essential concept. Central banks in other parts of the world operate on the basis that banks must conform to the central bank’s monetary control and monetary policy, and that the central bank must be able to assure the safeness and soundness of banks and other financial institutions and the backup of liquidity in times of stress. Those functions can be performed without requiring membership, and they can be performed, in this case, without in any way changing the nature of the dual banking system.

The Chairman. I think that was an excellent answer except for one part of it, which I think was implied there. How about the very last part—universal reserves you say would be essential. You implied that.

Mr. Miller. Universal reserves is the only system I know of that solves the problem of fairness once and for all. What we have now of course—as this committee well knows—is a logical trend of financial institutions developing payment services and performing other functions that have, in the past, been restricted to banks. We have the new development of NOW accounts. We have share drafts developed by credit unions, which means that credit unions are holding demand deposits and providing checking accounts. Many mutual savings banks are now authorized by State law to offer checking account services, and we can expect savings and loans to begin to creep into these new areas of service.

So the fairest system would be universal reserves. It’s not the only way to go, and I would not want to mislead you, Mr. Chairman, by saying it is. The other way to go, if we maintain the concept of membership—and this was the alternate proposal by the Federal Reserve—is to reduce the burden of membership so that members could compete fairly with other institutions. That is the reason for the suggestion of limited payment of interest on reserves, controlled by Congress. If we do not have universal reserves, at least the cost or burden of being a member as compared to a nonmember would be more equitable.

The Chairman. By and large, interest on reserves would be a more
equitable way. Everybody would be treated alike and it would solve the problem once and for all, as you say, because there would be no question of the universality and any possible erosion of this degree of monetary policy effect.

Mr. Miller. The preferable solution, if at all possible, is universal reserves. A fallback position or an alternate solution is workable, but not as fair.

The Chairman. Now it’s sometimes argued that the reserve requirements structure currently in place weakens monetary policy because the reserve multiplier is difficult to predict. Your chart 10 indicates that that might become increasingly the case as fewer and fewer institutions become subject to reserve requirements. Your proposal would simplify the structure somewhat but not completely.

Why shouldn’t reserve requirements on the same type of deposit liabilities be the same for all banks and other depository institutions, except the small institutions?

Mr. Miller. You’re correct; there certainly would be merit in looking at ways to simplify the structure toward more uniform reserve requirements as well as universal requirements. When we’re talking about uniform reserves, we mean that regardless of the size of institution, required reserves would be the same for the same class of liability. I would agree with you on taking that direction.

The Chairman. Chairman Reuss has proposed another solution to the Federal Reserve problem. His new bill would have universal reserve requirements against all deposits at banks with total deposits of $100 million or more and set that, as you know, at 6½ percent, and for banks with less than $100 million the reserve requirements would be set at zero percent.

Have you commented to Chairman Reuss on his proposal and, if so, what is the Board’s view of it?

Mr. Miller. Senator, let me go back just a moment. On Friday afternoon we had a discussion with Chairman Reuss on his proposal. The final version of his bill, I believe, was introduced on Friday, and we had the benefit of an extended session with him on Friday. Over the weekend, our staff studied his proposal; last night we held a meeting of the Board of Governors; and this morning we submitted to the House committee our comments on his proposal. We find a good deal of merit in much of the proposal.

There are a few areas where we feel that it would be desirable—indeed, highly desirable—to make some further adjustments. If you would like, I could tick those off. Otherwise, I can submit a copy of our letter, which is just off the press, for the record.

[The letter and attachments follow:]
SECTION 2 OF THE BILL ON REPORTING REQUIREMENTS

Certain minor changes in this section would be desirable. They are shown, in attachment A, as copy in bold brackets for deletions and italic type for insertions.

SUBSECTION (r) (1) THROUGH (r) (4) ON RESERVE REQUIREMENTS AND EXEMPTIONS

These subsections of H.R. 13847 change the reserve requirement structure in the Federal Reserve Act by placing the same reserve requirements on virtually all domestic liabilities of banks, apply this reserve requirement to nonmember banks, but exempt the first $100 million of these liabilities at each bank—member or nonmember—from reserve requirements. Certain changes in these provisions, however, would enhance the effectiveness of monetary policy.

For purposes of reserve requirement policy, it is essential to distinguish between demand and savings deposits, on the one hand, and time deposits, on the other. A shift to a uniform reserve requirement for demand and savings deposits is reasonable at this time because savings deposits are beginning to be employed more actively in the payments mechanism, and this tendency will become much more marked after November 1, when automatic transfers from savings deposits to demand deposits are permitted. However, a reserve requirement range and structure for time deposits different from demand and savings deposits is needed for the following reasons:

(a) Time deposits, particularly shorter-term instruments, are used by banks in liability management to expand or contract bank credit. Reserve requirement flexibility in this area would permit the Board to affect the cost and volume of bank credit without affecting expansion in the basic money supply. This suggests the need for a fairly broad reserve requirement range on time deposits, particularly for shorter-term time deposits.

(b) Longer-term time deposits are not transactions-type balances, but are more in the nature of financial investments. Thus, for monetary policy purposes, the reserve requirement can be relatively low and the range of permissible reserve ratios limited.

(c) A reserve requirement on time deposits as low as 1 per cent—which is the ratio that the Board would initially expect to impose—would work to offset the increased reserve burden from raising the reserve ratio on savings deposits as contemplated under this bill.

H.R. 13847 also requires that reserve requirements be imposed on “net Federal funds and other borrowings” which mature in 48 hours. The Board currently has authority to define such sources of funds as deposits for reserve requirement purposes. The impact of such a change needs further study because imposing reserve requirements on those borrowings would represent a drastic change in banking practices and would also affect the U.S. Government securities market (since a significant portion of these borrowings are repurchase agreements against U.S. Government securities). Under these circumstances, it would not seem desirable for the bill to require the imposition of reserves on such borrowings. However, if the bill did have such a requirement, it might best be confined to borrowing by banks from sources other than commercial banks, and the applicable ratio might be the same as that on time deposits. A reserve requirement on interbank borrowings would unduly inhibit the present institutions arrangements for smoothly distributing available reserves through the banking system.

The proposed bill exempts the first $100 million of reservable liabilities from reserve requirements, and indexes the future level of exemption to the rate of growth in nominal GNP. The Board is troubled by these provisions. With regard to exemption level, the Board strongly urges a $25 million exemption for the total of demand and savings deposits and another $25 million for time deposits—yielding a total exemption of $50 million. Such an exemption would mean that 74 per cent of total bank deposits would be at institutions required to hold reserves set by the Federal Reserve, virtually the same as now. It would exempt about 3,850 members from reserve requirements and would impose requirements on about 1,170 nonmember banks, or 15 per cent of total nonmember banks.

Economic and monetary policy concerns argue strongly against indexing of the exemption level, quite apart from the administrative complexity of an indexing system. With an exemption totalling $50 million the percentage of deposits subject to reserve requirements would be at a barely satisfactory level for purposes of monetary control. That exemption also increases the risk of disruptions in the
payments mechanism because of the sharp cut in the number of banks required to hold cash reserves, and some of these banks are sizable enough to perform clearing functions at least on a regional basis. While these risks might be acceptable initially to achieve the over-all benefits of the bill, the indexing proposal in the bill would probably preclude any improvement over time. Indeed, it may well worsen the situation since reservable bank deposits could well grow less rapidly than nominal GNP as a result of increased competition for transactions and other balances from nonbank depository institutions, which have a higher interest rate ceiling on deposits. However, if the Committee wishes to legislate some automatic adjustment of the $25 million exemption level, that level might be indexed to the rate of growth in real GNP, which would allow for future normal expansion in the economy.

The Board suggests that section (b) (1) of the bill be amended to include only demand and savings deposits as reservable liabilities for purposes of that section, to remove the indexing of the exemption, and to set the size of the exemption at $25 million for these liabilities. An amendment to this effect is shown as attachment B.

To provide some added flexibility for monetary policy, and to set the reserve requirement ratio initially at a level that is not excessively costly to the Treasury, given the proposal for time deposits to be described below, it is also suggested that the language of subsection (b) (4) (A) be amended in accordance with attachment C. This amendment has the effect of imposing an 8 percent reserve requirement on the total of reservable demand and savings deposits, and provides flexibility to vary this ratio between 7 and 9 percent.

Attachment D suggests an amendment to subsection (b) (4) (B) that would generalize the authority now contained in that subsection, which gives the Board some added reserve requirement flexibility. In light of the Board's recommendation to distinguish time deposits from demand and savings deposits for reserve requirement purposes the proposed amendment is technically necessary to apply the authority to all classes of liabilities subject to reserve requirements.

To allow for the separate reserve requirement on time deposits the Board proposes a new subsection (b) (5)—with present subsection (b) (5) being appropriately renumbered. This proposed subsection, shown in attachment E, would permit an average reserve requirement range of 1 to 6 percent for time deposits with initial maturities of 179 days or less, and a range of 1 to 3 percent for longer-term time deposits. Suggested language that would encompass borrowings other than from commercial banks is shown in brackets, should the Committee wish to legislate reserve requirements on such funds. The first $25 million of all liabilities in this subsection would be exempt.

SUBSECTION (7) ON THE DISCOUNT WINDOW

A broader access to the discount window, as is contemplated in H.R. 13847, is desirable because it would enhance the liquidity of the banking system. Subsection (7) of H.R. 13847 provides access to the discount window for nonmember banks exempt from reserve requirements upon certification of the FDIC or appropriate State supervisory authorities that access is needed to enable the bank to function on a safe and sound basis in meeting the needs of the local community. This proposal appears unnecessarily complex, and the Board suggests that nonmember banks exempt from reserve requirements be given access to the discount window on the same basis as member banks and as nonmember banks not exempt from reserve requirements, provided that access may be conditioned on a certification of solvency from the FDIC. A proposed amendment to that effect is shown in attachment F.

TRANSACTIONS BALANCES AT NONBANK DEPOSITORY INSTITUTIONS

The Board believes that it is important for equity and monetary police purposes to impose reserve requirements on transactions balances at nonbank depository institutions. Such balances are likely to become an increasingly large proportion of the nation's basic money supply. It is more practical to place reserve requirements on such balances now, when very few institutions would have to hold reserves, than at a later point when the imposition of reserves would place a substantial transition cost on the individual institutions. Proposed language that would accomplish this objective is shown in attachment G.

1 Only about five nonbank depository institutions would be subject, if the exemption were $25 million.
PHASE-IN

To ease the transition to reserve requirements on existing nonmember banks, a suggested amendment that would phase in reserve requirements over a four year period is shown in attachment H.

AFFILIATED INSTITUTIONS

Exempting a total of $50 million in deposits from reserve requirements provides a particularly strong incentive for banks to form new, affiliated commercial banking entities in order to avoid reserve requirements. A bank as large as $50 million would already enjoy many of the economies of scale, and thus the cost of creating new banks would be small relative to the benefit of avoiding reserve requirements.

It is proposed, therefore, that affiliated commercial banks have only one exemption for each category of deposits. Should the Committee adopt the proposal for transactions balances at nonbank depository institutions, a similar limitation should be imposed. Attachment I provides such language.

If the Committee wishes to provide relief from this proposal for existing affiliated institutions, grandfathering proposals could be considered. The Board urges that any such grandfathering provide that the total of exempt deposits for an affiliated group be equal to the number of similar affiliated depository institutions as of August 1, 1978, times the dollar level of the exemption for each category of deposits in the bill, provided that any individual affiliated institution would be subject to reserve requirements whenever its liabilities subject to reserves exceeded the exemption level of an individual institution. A proposed amendment along these lines is shown as attachment J.

PASS-THROUGH

The Board also would propose for Committee consideration an amendment that would permit nonmember institutions to hold reserves required by the Federal Reserve with member banks, Federal Home Loan Banks (in the case of savings and loan associations), or at a Central Liquidity Facility if established (in the case of credit unions), provided that these institutions pass such reserves through to a Reserve Bank on a dollar for dollar basis. Such an amendment, shown in attachment K, would permit existing correspondent relationships to be maintained.

I would like, once more, to extend my and the Board's appreciation for the intensive effort made by you and your colleagues on this very important matter.

Sincerely,

BILL.

ATTACHMENT A

AMENDMENT TO H.R. 13847 OFFERED BY

On page 1, beginning on line 6, strike all of Section 2 extending through line 19 on page 2, and insert in lieu thereof the following new Section 2:

"Sec. 2. Section 10 of the Federal Reserve Act is amended by adding at the end thereof the following new paragraph:

'The Board may require any depository institution specified in this paragraph to make, at such intervals as the Board may prescribe, such reports [of the total amounts of such categories] of its liabilities and assets as the Board may determine to be necessary or desirable to enable the Board to discharge its responsibility to monitor and control monetary and credit aggregates. Such reports shall be made (1) directly to the Board in the case of member banks and in the case of other depository institutions for all liabilities subject to reserve requirements, and (2) for all other reports to the Board through the (A) Federal Deposit Insurance Corporation in the case of insured State nonmember banks, Savings Banks, and Mutual Savings Banks, (B) National Credit Union Administration in the case of insured credit unions, (C) Federal Home Loan Bank Board in the case of any institution insured by the Federal Savings and Loan Insurance Corporation or which is a member as defined in section 2 of the Federal Home Loan Bank Act, and (D) such State officer or agency as the Board may designate in the case of any other type of bank, savings and loan association, or credit union. The Board shall endeavor
to the maximum extent feasible to avoid unnecessary burdens on reporting institutions and the duplication of other reporting requirements, and any data therefrom shall be made readily available to the Board. The Board may classify depository institutions for the purposes of this paragraph, and may impose different requirements on each such class."

Explanation.—Provides for direct reporting to Federal Reserve concerning reserve liabilities and covers savings banks and mutual savings banks.

**ATTACHMENT B**

**AMENDMENT TO H.R. 13847 OFFERED BY ____**

On page 2, strike line 23 and all that follows through line 14 on page 3 and insert in lieu thereof the following:

"(b) (1) For the purposes of this subsection—The term 'reservable liabilities' means, in the case of any State or national bank, the amount by which the sum of such bank's demand and savings deposits liabilities exceeds $25 million."

Explanation.—Redefines "reservable liabilities" to include only demand and savings deposits; establishes a $25 million exemption from reserve requirements for demand and savings deposits and eliminates indexing for such exemption.

**ATTACHMENT C**

**AMENDMENT TO H.R. 13847 OFFERED BY ____**

On page 4, line 1 strike all that follows through line 7 and insert in lieu thereof the following:

"(4) All banks subject to reserve requirements shall maintain reserves against their reservable liabilities in the ratio of 8 per centum, or in such other ratio not greater than 9 per centum and not less than 7 per centum as the Board may by regulation prescribe solely for the purpose of implementing monetary policy."

Explanation.—Establishes 8 percent reserve ratio with 2 percent discretionary range for demand and savings deposits.

**ATTACHMENT D**

**AMENDMENT TO H.R. 13847 OFFERED BY ____**

On page 4, beginning on line 8, strike all of subparagraph (B) through line 16. On page 5, after line 16, add a new subsection (8) as follows:

"(8) Upon a finding by the Board that extraordinary circumstances require such action, the Board may impose reserve requirements outside the limits otherwise prescribed by this Section for a period not exceeding 30 days but which may be extended for further periods not exceeding 30 days by affirmative action by the Board in each instance. The Board shall promptly transmit to the Congress a report of any exercise of its authority under this subsection and the reasons for such exercise."

Explanation.—Authorizes Board to impose reserve requirements outside limits otherwise prescribed for all classes of liabilities subject to reserve requirements.

**ATTACHMENT E**

**AMENDMENT TO H.R. 13847 OFFERED BY ____**

On page 4, after line 16, insert the following new subsection and renumber the following subsections accordingly:

"(b) (5) Subject to the exemptions in paragraph (C) of this subsection, banks other than savings banks and mutual savings banks shall maintain reserves against their______

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“(A) time deposits with initial maturities of 179 days or less [and against borrowings from sources other than commercial banks with maturities of one week or less and with such longer maturities as the Board may prescribe] in a ratio not less than one per centum nor more than 6 per centum, as shall be specified by the Board of Governors and their

“(B) time deposits with initial maturities of 180 days or more in a ratio of not less than one per centum nor more than 3 per centum, as shall be specified by the Board of Governors.

“(C) Reserve requirements imposed by this subsection shall apply only to that portion of the sum of the liabilities specified in paragraphs (A) and (B), regardless of maturity, which exceeds $25 million.”

Explanation.—Establishes reserve requirements for bank time deposits in excess of $25 million with different ratios for deposits with initial maturities of 179 days or less, and for deposits with longer maturities; establishes reserve requirements at the short-term time deposit ratio for borrowings from nonbank sources.

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ATTACHMENT F

AMENDMENT TO H.R. 13847 OFFERED BY

On page 5, amend subsection (7) by striking the balance of the subsection after “member banks” on line 10 and inserting in lieu thereof the following: “...except that the Board as a condition of access to or maintenance of such privileges may require a certification of solvency of such bank from the Federal Deposit Insurance Corporation.”

Explanation.—Entitles any bank, whether or not it maintains reserves with the Federal Reserve, to access to Federal Reserve discount and borrowing privileges on the same basis as member banks; eliminates a need for FDIC or State supervisory agency certification as condition to such access and in lieu thereof authorizes the Board to require a certification of solvency from the Federal Deposit Insurance Corporation of any such bank as a condition to such access.

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ATTACHMENT G

AMENDMENT TO H.R. 13847 OFFERED BY

On page 5, at the end of Section 3, add the following new subsection:

“(b) ( )

“(A) The term reservable liabilities means, in the case of any depository institution as specified in Section 10 of this Act, other than a bank subject to reserve requirements under subsection (b) (2), the amount by which such institution’s transactions deposit balances, as defined by the Board in consultation with the appropriate Federal depository institution supervisory agencies, exceeds $25 million.

“(B) Such depository institutions shall maintain reserves against their reservable liabilities in the ratio specified in subsection (b) (4).”

Explanation.—Estabishes reserve requirements for transaction accounts in excess of $25 million maintained at nonbank depository institutions in the same ratio applicable to demand and savings deposits at banks.

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ATTACHMENT H

AMENDMENT TO H.R. 13847 OFFERED BY

On page 5, after line 16 at the end of Section 3, add the following subsection:

“( ) With respect to any depository institution that is not a member of the Federal Reserve System on August 30, 1978, the required reserves imposed pursuant to this section on the effective date of this Act shall be reduced by 75 per centum during the first year that begins after the effective date, 50 per centum during the second year, and 25 per centum during the third year.”

Explanation.—Establishes a four year phase-in for reserve requirements imposed on nonmember institutions.
ATTACHMENT I

AMENDMENT TO H.R. 13847 OFFERED BY 

On page 5, after line 16 at the end of Section 3, add the following subsection:

"( ) The total deposit liabilities exempted from reserve requirements pursuant to subsection (1), (5), and ( ) [if nonbank transaction accounts are covered] for each such exemption shall not exceed $25 million in the aggregate for affiliated banks, [and $25 million in the aggregate for affiliated nonbank depository institutions.]

Explanation.—Provides that total deposits exempted from reserve requirements for all institutions in an affiliated group shall not exceed $25 million for each category of deposits.

ATTACHMENT J

AMENDMENT TO H.R. 13847 OFFERED BY 

On page 5 at the end of Section 3, add the following new subsection:

"( ) In the case of affiliated banks [and affiliated nonbank depository institutions,] the total deposit liabilities exempted from reserve requirements pursuant to subsection (1), (5), and ( ) [if nonbank transaction accounts are covered] shall not exceed in the aggregate for such affiliated groups the product resulting from multiplying the number of institutions in such affiliated group on August 1, 1978 by $25 million for each such exemption, provided that no more than $25 million shall be exempted under each such exemption at any individual bank [or nonbank depository institution]."

Explanation.—Provides that total deposits exempted from reserve requirement shall not exceed $25 million for each exemption in individual institutions, and for affiliated groups shall not exceed the number of institutions in such groups on August 1, 1978 times $25 million for each exemption.

ATTACHMENT K

AMENDMENT TO H.R. 13847 OFFERED BY 

On page 5, after line 16, add a new subsection as follows:

"( ) Section 19(c) of the Federal Reserve Act, as amended (12 U.S.C. § 461) is amended to read as follows: "Reserves held by any depository institution to meet the requirements imposed pursuant to subsection (b) of this section shall be in the form of—"

"(1) Balances maintained for such purposes by such depository institution in the Federal Reserve bank of which it is a member or at which it maintains an account. However, the Board may, by regulation or order, permit depository institutions to maintain all or a portion of their required reserves against their nontransaction accounts in the form of vault cash: Provided, That such proportion shall be identical for all depository institutions; and

"(2) Balances maintained by a nonmember depository institution in a member bank, in a Federal Home Loan Bank, or in a central liquidity facility that may be established for credit unions: Provided, That such member bank, Federal Home Loan Bank, or central liquidity facility maintains such funds in the form of balances in a Federal Reserve bank of which it is a member or at which it maintains an account. Balances received by a member bank from another depository institution that are used to satisfy the reserve requirement imposed on such depository institution by the section shall not be subject to the reserve requirements of this section imposed on such member bank and shall not be subject to assessment imposed on such member bank pursuant to section 7 of the Federal Deposit Insurance Act, as amended (12 U.S.C. § 1817)."

Explanation.—Specifies that reserves may be held in the form of balances at Federal Reserve banks, or of vault cash, and that a nonmember institution may hold reserves at a member bank, at a Federal Home Loan bank (in the case of savings and loan associations), or at a central liquidity facility (in the case of credit unions), provided that these institutions pass the reserves through to a Reserve bank on a one-for-one basis.
The CHAIRMAN. We would appreciate that very much.
I'm concerned with the high level of the exemption, whether $100 million is desirable, necessary, fair; whether it shouldn't be a somewhat lesser amount. It seems to me maybe $50 million might be more appropriate under present circumstances.

Mr. Miller. Mr. Chairman, may I just tick off some of the major areas that our Board of Governors thought should be modified. The Board of Governors felt the exemption was too high. We also felt—and I believe Chairman Reuss agrees with this—that while we should have substantially uniform reserves, the reserves on demand and possibly savings deposits should be set at a different level than those on time deposits. I believe Chairman Reuss agrees with our suggestion.

Our suggestion is that there be an exclusion of demand and savings deposits under $25 million and an exclusion of time deposits under $25 million, for a total exemption of $50 million, as compared to Chairman Reuss’ suggestion exclusion of $100 million.

The advantage of that structure is great. It would increase, substantially, the amount of deposits subject to reserve requirements—with the benefit shown in chart x—and it would assure an adequate number of institutions maintaining reserves for an adequate involvement by the Central Bank. Our estimate is that about 2,900 banks would be subject to reserve requirements using that formula. As you know, right now there are about 5,700 member banks. So, in a sense, the number of banks subject to reserve requirements would change.

On the other hand, some larger institutions who are not now subject to reserve requirements would be. Overall, we feel the formula would work out well.

Our second comment is that while Chairman Reuss’ proposal is a very constructive one, it does limit universal reserves to banks. We continue to feel that universal reserves is the solution if possible, but it should be applied to all transactions balances—at S. & L.’s, mutual savings banks, and credit unions. If this were done today, only five additional institutions would be covered, but the principle would be established so——

The CHAIRMAN. You say if this were done, only five additional institutions would be added if you covered not only the banks but the non-banks?

Mr. Miller. Yes, sir, with the $25 million exclusion.

The CHAIRMAN. With the $25 million limit?

Mr. Miller. Yes.

Senator Schmitt. Excuse me. Would the chairman yield?

The CHAIRMAN. Surely.

Senator Schmitt. Does that include credit unions?

Mr. Miller. Yes, sir, that would include credit unions. With a $25 million exclusion, no credit union would be covered right now. But the point is that the rules would then be known, and that as these institutions seek out and opt for transactions accounts, they would know the ground rules. They would know that if they want to be like banks in that area, they would have to compete like banks. We would very much like to see that happen.

We have a few other suggestions. We are particularly concerned about a loophole in the case of the proposal as to multibank holding companies. We certainly wouldn’t want the effect of the exclusion to produce an incentive for banks to begin to divide up—for every insti-
tution to become a series of banks small enough to be exempt from reserve requirements. We would want to be sure to find a consolidated approach and not let the divide and conquer principle creep in. We have made a few technical suggestions about this and also some about time deposits.

The letter that we submitted to Chairman Reuss this morning can be made available to you, and I'd be happy to pursue this in more detail.

The Chairman. Currently, Federal Reserve policy, as we all know, is implemented primarily through Open Market activities. That is, by buying and selling Federal obligations. You do that rather than changing reserve requirements and there's obviously both pressure to reduce reserve requirements from the banking institutions—it's very profitable to them if they are reduced—and pressure against it from Members of the Congress and members of the public and others who feel this deprives the Treasury of revenue they otherwise would have.

But, at any rate, using open market operations doesn't seem to hurt the effectiveness of your monetary policy. It seems to be able to work rather well that way.

In light of this, why does the Federal Reserve continue to ask for broad flexibility to change reserve requirements? Do you really need a range of 7 to 22 percent for demand deposits, 3 to 12 percent for transactional accounts, and 1/2 percent to 10 percent for time deposits? It's a tremendously broad range. It would seem there's no real congressional limitation at all, in effect.

Mr. Miller. Mr. Chairman, in formulating our proposal we had many things to consider. Of course, one was the cost impact of the possible solutions. We proposed relatively modest reductions in reserves and, of course, maintained the statutory concept of different sizes of banks being treated in different ways.

My only answer is that if we can go to universal reserves, then the degree of flexibility we need for changing reserve requirements could be very substantially narrowed.

The proposal Chairman Reuss has made, as you mentioned, would set reserve requirements at 6½ percent, with the authority to move them up or down half a point—a very narrow band. In our discussions with him Friday, when pointing out the desirability of distinguishing between demand and savings deposits on the one hand and time deposits on the other, we suggested a reserve requirement initially, of 8 percent on the former deposits, with authority to move from 7 to 9, which is also very narrow. I believe Chairman Reuss feels that is quite workable, at least that degree of flexibility. We might change the figures a little as we study the impact of narrowing the band.

On time deposits, it was our suggestion to his staff that we be given a leeway of 1 to 6 percent on reserve requirements for short-term time deposits—179 days or less—where more control through reserves might be desirable, and that the reserve requirements on longer term time deposits—180 days or longer—be in a band of 1 to 3 percent.

The Chairman. All this hinges on universal reserve requirements?

Mr. Miller. Yes, sir.

The Chairman. And if so, you say we could limit the ranges and the flexibility and that's very, very helpful.

Mr. Miller. There was another provision which we did not propose, but which the chairman of the House committee did; that was, that given so narrow a range, if there were unusual circumstances, the
Board would be given authority to set reserves outside the range for a 30-day period and then report to Congress on the circumstances. Congress then would be able to react—either to confirm the action or take alternate action if it felt that reserves should be put back into the band. It's a very workable kind of plan.

I must just caution that this limiting of ranges is based entirely on the prospect of having universal reserves; that makes other things possible. You're certainly correct in pointing out that the present structure has a historical base, but it may not be the best solution for the 1980's and 1990's or for the next century. You were also correct in pointing out that given the burden on members and the competitive advantage of nonmembers, the pressure on the Federal Reserve has been to reduce reserve requirements in order to reduce inequalities. Therefore, for some time, there hasn't been much use of reserve requirements as a monetary tool. But it's important to keep that flexibility, either by maintaining some band or for emergency conditions. It's particularly important to keep some flexibility so that we can affect the cost and availability of short-term time deposits. There are times when that flexibility would be desirable.

The Chairman. Senator Schmitt.

Senator SCHMITT. Thank you, Mr. Chairman.

Chairman Miller, I apologize for missing your testimony. I came in as rapidly as I could.

I am concerned about two things I guess immediately that come to mind. One is the relative effect of the proposals not only that you have made but also that Congressman Reuss has made, and your response to his proposals, on the small banks. I realize you're suggesting a cutoff so that smaller banks are—very small banks are not impacted, but still there are small banks, and where we have had universal anything—regulations or reserves or what have you—there still proportionately seems to be an extra burden on small banks. Would you talk to that a little bit? Like State-chartered banks, for example. They would have the reserve requirement presumably but it would be at a cost.

Mr. MILLER. Senator Schmitt, the proposal that Chairman Reuss has made for a $100 million exclusion would virtually exclude all banks that could be classified as small. So there would, I think, be complete relief for what we think of as small banks.

Our alternate proposal—to have a $25 million exclusion for demand and savings deposits and a $25 million exclusion for time deposits for a total of $50 million—would subject only about 3,000 banks to reserve requirements. Once again, I would have to say that no small banks would be subject to reserves. There are 14,395 banks and 11,470 would not be required to maintain any reserves under our proposal. About 3,000 would, and, with the $50 million exclusion, they would have to be very good-sized banks before reserves would be required. Of course, once they are subject to reserves, the requirement would be satisfied initially with vault cash, so it would have to be an even bigger bank before there was actually an impact.

In terms of the regulatory burden, there's also a lot of merit to the proposal. While about 74 percent of total bank deposits would be subject to the reserve requirement, we would virtually eliminate all small banks from the requirement.
I realize I'm talking about a new proposal that you probably haven't even seen; it's Chairman Reuss' proposal that I was just discussing with Chairman Proxmire.

Senator Schmitt. Now the other issue that I understand you did talk to some that is of concern to both of us, because we have talked about it both publicly and privately, and that is the ability to measure the money supply.

Now presumably the universal deposits would improve the Fed's capability to understand over a broad period of time just what is happening to the money supply. Is that correct?

Mr. Miller. That's correct.

Senator Schmitt. Would you explain that summary again for us, please?

Mr. Miller. Let me make a couple of observations. One is that it would be very helpful to the Federal Reserve to have current data on the liabilities of banks. One proposal that has been made is for an amendment to give us access to data through the other regulatory agencies; that would be helpful. We have suggested that data collection be direct in the case of any institution that is required to maintain reserves with the Federal Reserve, which would expedite our getting current information and improve the predictability of our actions.

I don't know whether you have copies before you, but Chart 10 attached to my testimony (p. 32) illustrates the point better than any statement I could give you. As you move from left to right along the bottom scale of that chart, you are moving from zero to 100 percent on bank deposits not subject to reserve requirements. Or, to make the reciprocal statement, on the left side 100 percent of deposits are subject to reserve requirements and on the right side, zero. As you move from left to right—covering less and less bank deposits with reserve requirements—the vertical scale shows you the increase in the degree of unpredictable variability in M1 or M2. This illustrates how important it is for us to have, not only the data, but a substantial amount of deposits subject to reserve requirements so that we have the leverage to increase the predictability of the money supply. This, of course, greatly enhances the probability that Federal Reserve policies will accomplish what is intended; the more accurately we're able to predict the situation, the more likely monetary policy will have the predicted consequence. That's what we're after.

Senator Schmitt. Short run means what, in terms of time frame?

Mr. Miller. Short run, in this case, means a 2-month period.

Senator Schmitt. Do you think the Fed, intending to focus on that as a minimum time frame for any kind of predictability of the money supply, is a useful predictability?

Mr. Miller. Of course we need to get much more predictability over the long term; there's no doubt about that. But to handle the long term, we first need to get control of the short term. If we can predict what will happen in a 2-month cycle, I think we will be that much farther along in being able to get inside the ranges of tolerance we are seeking to achieve in the long terms.

Senator Schmitt. But I believe you agree that you can get too short.

Mr. Miller. That's correct.

Senator Schmitt. You can get too myopic.
Mr. Miller. You have to be extremely cautious about the volatility of 1-week figures, and of 2-month and 3-month figures. While we don’t want to concentrate on the weekly figures, we need to know how the weekly figures fit into a pattern in order to predict what will happen over a 3-month period. Once we get that better 3-month predictability, we won’t have as many surprises popping up in the money supply and we won’t always be trying to react quickly to get back within our ranges. That’s what gets us into trouble.

Senator Schmitt. Thank you, Mr. Chairman.

The Chairman. I have just a few more questions. I’d like to ask about the surplus account. You talked in your presentation about the fact that the cost to the Treasury in the first 3 years would be nothing because of the fact the Federal Reserve would cover it by returning surplus to the Treasury. You have over $1 billion in your surplus account and, as I say, your proposal includes a transfer of about half of that to the Treasury to offset the cost of interest payments on reserves. In the past, part of the surplus has been transferred to the Treasury simply because the surplus got too large.

What I want to know is why you need a surplus in the first place? Why shouldn’t the whole thing be transferred to the Treasury? That would reduce the deficit, tend to reduce the national debt, $1 billion isn’t much, but if it’s added up it comes to something.

Mr. Miller. It does add up to a lot of money to me.

Mr. Chairman, I will give you several reasons why I think the Federal Reserve surplus might be desirable. One is that it’s very helpful to have a surplus in order to cushion any change in policy, such as we’re considering, that otherwise would have an immediate impact on the Treasury. It’s helpful to have a surplus against any contingency—

The Chairman. It’s hard to imagine another contingency like this coming along.

Mr. Miller. Who knows? A war, a national emergency, an international crisis. One could see the need for several hundred million dollars.

The Chairman. The usual need for a surplus for a bank is, of course, so it won’t fail and so it won’t have a liquidity problem. You have nothing like that at all. Obviously you have no liquidity problem. The Federal Reserve cannot fail, by definition almost.

Mr. Miller. One reason is for a contingency—

Senator Schmitt. I hope the chairman is right.

The Chairman. Well, I can’t imagine a scenario. I’d like to hear one. What other bank has a positive cashflow of $6 billion or earnings that are six times its surplus?

Mr. Miller. The second reason is that if we transfer the $1 billion we let everybody off the hook on the deficit. But it’s just a one-time shot. We hope Congress will not want to take advantage of a one-time adjustment and is looking at the necessity for fiscal discipline and a fiscal plan that doesn’t rely on that.

I’m hoping we can manage the economic affairs of this Nation so that interest rates will come down significantly, in which case our earnings would shrink.

The Chairman. Why wouldn’t this help the interest rates come down? It would mean the Treasury would borrow $1 billion less.

Mr. Miller. I would certainly be happy to discuss with the Governors whether they would like to declare a dividend.
The CHAIRMAN. Let me ask you another one because this occurred to us while you were discussing the Reuss proposal.

Do you have any preliminary estimates of the net cost of the Reuss proposal or the net cost of your counterproposal? Your counterproposal would cost less, as I understand it, substantially less.

Mr. MILLER. Yes. Our counterproposal, with certain adjustments that we have suggested in handling federal funds and repurchase agreements, would reduce Federal Reserve earnings by about $675 million gross. If we charge for services—charges on the order of $400 million—the net reduction in Federal Reserve earnings would be about $275 million.

The CHAIRMAN. I was thinking of the Reuss proposal which would simply provide—

Mr. MILLER. Yes, sir. The Reuss proposal, according to our calculations—

The CHAIRMAN. Provide the universal reserves with a cutoff of $100 million, and your counterproposal that goes to $50 million. So yours would cost less because you would have reserves extend over more banks.

Mr. MILLER. Without including the added revenues from pricing Federal Reserve services it appears that the Reuss proposal would involve a reduction of Federal Reserve earnings of about $190 million; our proposal would cost about $420 million. So you could compare $190 million against $420 million. But we also suggested a slightly different treatment of Federal funds and repurchase agreements because of the potential effect on the market in Government securities of requiring reserves on repurchase agreements. With those adjustments our cost goes up to $675 million as compared to about $500 million under the Reuss proposal.

The CHAIRMAN. Would you provide for the record the breakdown of your analysis of the cost?

Mr. MILLER. Yes, sir; we would be very pleased to do so.

[Chairman Miller subsequently submitted the following information:]

EFFECTS ON EARNINGS OF THE FEDERAL RESERVE SYSTEM OF UNIVERSAL RESERVE REQUIREMENT PROPOSALS,
AUG. 14, 1978 ¹

[In million of dollars]

<table>
<thead>
<tr>
<th></th>
<th>Reuss proposal²</th>
<th>Board proposal³</th>
</tr>
</thead>
<tbody>
<tr>
<td>Change in reserves held at Federal Reserve banks:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Members</td>
<td>4,885</td>
<td>9,564</td>
</tr>
<tr>
<td>Nonmembers</td>
<td>1,929</td>
<td>2,494</td>
</tr>
<tr>
<td>Total reserves released</td>
<td>-2,954</td>
<td>-6,468</td>
</tr>
<tr>
<td>Reduction in Federal Reserve earnings ⁴</td>
<td>192</td>
<td>420</td>
</tr>
</tbody>
</table>

¹ Based on Call Report and TEDS data, December 1977.
² 6¼ percent reserve ratio against net demand deposits, Federal funds purchased, other liabilities for borrowed money, Eurodollars, savings deposits, plus time deposits after exempting the 1st $100,000,000 of such liabilities. (Nonexempt Federal funds purchased, other liabilities for borrowed money, plus Eurodollars amount to about $87,000,000,000. If the reserve ratio on these liabilities were lowered to 1 percent, Federal Reserve earnings would be reduced an additional $311,000,000.)
³ 8 percent reserve ratio against net demand deposits, Federal funds from nonbank sources, other liabilities for borrowed money, Eurodollars, plus savings deposits, after exempting the 1st $25,000,000 of such liabilities. 1 percent reserve ratio against time deposits in excess of $25,000,000. (Nonexempt Federal funds from nonbank sources, other liabilities for borrowed money, plus Eurodollars amount to about $56,000,000,000. If the reserve ratio on these liabilities were lowered to 1 percent, Federal Reserve earnings would be reduced an additional $255,000,000.)
⁴ Estimated as if reserves released would earn a 6½ percent rate of return. (Note that the net cost to the Treasury—afters taxes on income of banks and stockholders—would be about 45 percent of these figures.)
The Chairman. It's not clear from the language of the bill whether it's the Federal Reserve's intent to count vault cash as a reserve as they are now. The legislation says the Board may permit all or a portion of the required reserves against transaction accounts in the form of vault cash. Do you intend to count vault cash as reserves?

Mr. Miller. Yes; we intend to.

The Chairman. Why shouldn't the legislation be written to say that?

Mr. Miller. I see no objection to that.

The Chairman. The Federal Reserve has never been in favor of open access to nonmembers and thrifts. If the membership problem is resolved by universal reserves, do you see any problems with open access?

Mr. Miller. No, sir. If we had universal reserves, it would be desirable to look at universal access on the same terms and conditions as members.

The Chairman. Now in the 1974 Universal Reserve Requirement bill, access to discount window would have been granted to the banks holding reserves at the Federal Reserve banks. That feature is absent from your current proposal and yet you express concern about safety and soundness of banks because of lack of access to the discount window.

Why shouldn't this legislation provide access to the discount window for banks required to meet Federal Reserve requirements?

Mr. Miller. If we should have a universal reserve requirement, it would be well to go to more universal access to the window. As a matter of fact, in the letter we sent to Chairman Reuss we make an even broader suggestion: If the universal reserve approach should be enacted, we would suggest that all financial institutions with transactions balances have access to the window on the same terms and conditions as members, with the provision that we would have the right, if we felt it necessary, to ask the FDIC to give us a certification of solvency of an institution. So we are moving in the direction you indicate, and I think this is one area we should seek to perfect in this legislation.

The Chairman. I have just one more question. Your proposal indicates that should the Congress enact uniform reserve requirements, the Board would need to reconsider whether and to what extent its proposal for service charges and interest on reserves might need to be adjusted. I'm not sure I know the meaning of that statement. Do you or do you not think that charging for Federal Reserve services and interest on reserves are a good idea in their own right first?

Mr. Miller. Mr. Chairman, that statement was, as you say, based on the assumption of universal reverses. There would no longer be any burden, because there can be no burden if everybody is treated the same. It's the discrepancy in reserve requirements that creates the burden.

At that point, one could reexamine the desirability of charging for services and simply decide that the Federal Reserve should provide services to all institutions. While the Board didn't have time to cross that bridge, it seems to me that, even if we had universal reserves, it would be desirable to have a system of charging for services because that would create the discipline of choice, alternatives—competition—
and it would be another contribution toward improving the whole banking and financial structure.

The Chairman. I agree with that wholeheartedly. Also, it might—as has been indicated by National City Bank and others—increase competition. I think that would be a good thing.

Mr. Miller. It seems to me it would be. Our services are not free; they are in exchange for maintaining reserve balances. But because they are not explicitly priced, the tendency is to make them more attractive in order to soften the reserve burden. The result quite often, it seems to me, has been not to make the highest and best use of resources. The better allocation of resources would be to have a competitive system. With due respect, Mr. Chairman, there must be some basic services provided by the central bank so that rural or remote areas aren’t neglected because nobody is willing to serve them.

The Chairman. Would you put this into effect without a congressional mandate should universal reserve requirements be legislated?

Mr. Miller. Yes, sir.

The Chairman. You would?

Mr. Miller. The contemplated plan—if we should set universal reserves, on the basis of the Board’s meeting yesterday—would be to go forward with a charge for services.

The Chairman. Senator Lugar.

Senator Lugar. I have no questions.

The Chairman. Senator Schmitt.

Senator Schmitt. Mr. Chairman, pursuing this topic that you just introduced, I guess what the basic proposal then boils down to, is what is commonly called a carrot and stick approach or the apple and spur approach, depending on what part of the country you come from, where the spur is the universal reserves. That would be an increased burden on some, but the anticompetitive aspect of it would disappear because it would be uniform. On the other hand, to balance that, you would favor paying interest on reserves that are required and I guess a general lowering of reserve requirements. Is that a correct assessment?

Mr. Miller. Senator Schmitt, when our proposal first came forward it had two pieces. They’ve been connected into one piece in the Senate proposal, but we looked upon them as two separate proposals because they could be handled discretely. If there were universal reserves, it would not be necessary to pay interest on reserves because there would be equal treatment. There would be no membership burden. Therefore interest on reserves would be a question of choice on which Congress might express an opinion. But our thought at the time we introduce our proposals was that, if universal reserves were enacted we would not pay interest on reserves because there would be no need for a carrot. Everybody would be on an equal basis.

Senator Schmitt. But at an extra cost; right?

Mr. Miller. At an extra cost.

Senator Schmitt. For everybody.

Mr. Miller. Yes; but we did think that if we were to stay within the present reserve structure, if we wanted to charge for services we would need to pay interest on reserves to wash out the cost. I want to
distinguish between a system of universal reserves and the present reserve structure. Under the present structure, if we desire to charge for services, then we need interest on reserves so as not to add additional costs to banks which the consumer would ultimately pay. If, as the chairman is now talking about, we have universal reserves with substantially reduced reserve requirements and more uniformity, then the problem suddenly becomes a bit different: Interest on reserves might become an unnecessary feature; there would be room to charge for certain services.

The institutions that would face an additional cost burden would be large nonmembers, who are not now subject to reserve requirements. Under our proposal of a total $50 million exclusion, about 1,100 nonmembers would be required to maintain reserves. But those would be large institutions competing with similarly large members and equity would seem to me to say they should play by the same rules as their competitors.

Senator Schmitt. But nevertheless, those 1,100 institutions that would be covered would have for themselves some increased burden.

Mr. Miller. No question about that.

Senator Schmitt. The reserves, plus the cost of services.

Mr. Miller. That burden could be reduced to zero if interest were paid on reserves. The problem is then one of how much it costs the Treasury to pay interest on a large amount of deposits.

Senator Schmitt. I understand.

Mr. Miller. That's the tradeoff we're trying to examine.

Senator Schmitt. I guess I tend to agree in general, although we might disagree in specifics, that if institutions are providing the same general class of services they should be playing by the same rules. We have discussed that already with respect to the foreign bank issue as well as now discussing it with respect to domestic bank.

Thank you, Mr. Chairman.

The Chairman. Thank you very, very much, Mr. Chairman.

Mr. Miller. This has been a very, very helpful discussion for us, and I appreciate it, Mr. Chairman.

The Chairman. It's very helpful testimony and we've made a fine record.

I'm going to ask a panel to come forward, the panel of the Honorable George LeMaistre, Chairman of the Federal Deposit Insurance Corporation; Lawrence Connel, Administrator, National Credit Union Administration; and Dr. Kenneth Biederman, Director, Office of Economic Research, Federal Home Loan Bank Board.

Mr. LeMaistre, we are honored to have you. I understand this will be your last appearance, your farewell appearance, before a congressional committee, and in your honor I wore your tie, your FDIC tie this morning, given to me by an FDIC staff member, I'll confess. But it was at a Christmas party when the spirit of giving and receiving is I think pretty plutonic. So go ahead. We are happy to have you.

For the convenience of you gentlemen and for the convenience of the committee, we are going to see if we can confine the oral testimony, if possible, to 10 minutes or less and then we will have some questions for you.

Chairman LeMaistre, go right ahead, sir.
STATEMENT OF GEORGE A. LeMAISTRE, CHAIRMAN, FEDERAL DEPOSIT INSURANCE CORPORATION

Mr. LeMAISTRE. Thank you, Mr. Chairman. I will summarize the prepared statement which has been filed and I do appreciate the opportunity to testify before this committee and present our views on the Federal Reserve Requirements Act of 1978, S. 3304. This bill deals with attrition in Federal Reserve System membership and related matters by: (1) Establishing universal reserve requirements for all commercial banks and for other depository institutions offering transaction accounts; (2) paying interest on reserves and reducing reserve requirements; and (3) charging for Federal Reserve services now provided free only to member banks or to institutions that belong to automated clearinghouses.

Let me begin by stating our view that the legal requirement that Federal Reserve member banks maintain sterile reserves is inequitable to them and inequitable to their customers. However, we strongly oppose the establishment of universal reserve requirements as a way of removing this inequity. The payment of interest on reserves and pricing of services, however, are attractive and deserve thoughtful and sympathetic consideration. In considering these proposals it must be kept in mind that redressing the imbalance between member and non-member banks raises many of the difficult issues with which the Congress has been wrestling, without resolution, for a number of years. These include, notably, the effective conduct of monetary policy; the balance between the State and national banking systems; the changes in the Federal regulatory structure, particularly whether the Federal Reserve should continue to exercise supervisory authority; and, regulatory reform, particularly whether interest rate ceilings and the prohibition of interest on demand deposits should be abolished.

The Federal Reserve has stated its belief that the decline in the proportion of deposits held by member banks caused by membership attrition adversely affects the precision with which monetary policy can be conducted. There have been a number of studies of monetary control in this country that have concluded that increased Federal Reserve membership and legal reserve requirements are not important to the effectiveness of monetary policy. The studies are cited in my prepared statement and in the interests of time I shall not discuss them except to say that the evidence and opinions on this issue are distinctly one-sided. Knowing the tendency for economists to disagree, the unanimity in this case is impressive.

What the Federal Reserve does need to conduct monetary policy effectively is timely and accurate information about monetary aggregates. S. 3304 would require depository institutions to report their deposit liabilities and required reserves directly to the Federal Reserve. We support making such information available to the Federal Reserve and have no objection to the adoption of the proposal in S. 3304 that would do this.

In this regard, the FDIC has already been providing its assistance to the Federal Reserve. In the spring of 1976, the FDIC instituted a special schedule in the quarterly call report for all nonmember banks to provide the Federal Reserve with better information on the money
supply. Also, beginning the first week of July 1977, a sample of 580 nonmember banks began reporting deposit and cash items on a regular weekly basis, the same items as all nonmember banks report four times a year. The Federal Reserve has indicated that it expects the data from these two surveys to enable significant improvements in its estimates of the nonmember bank component of the Nation's money supply. The FDIC and the Federal Reserve have agreed to review this program in mid-1979 to determine whether nonmember bank data are necessary for monetary policy purposes and, if they are, whether the sample of 580 nonmember banks is adequate. To date the Federal Reserve has voiced no dissatisfaction with this arrangement.

In summary, we believe the need for legal reserve requirements for monetary control purposes is not supported by the weight of available evidence. The evidence to date suggests that monetary policy effectiveness depends on adequate data, proper estimation procedures, and appropriate open market operations decisions, and not on reserve requirement jurisdiction.

We believe the dual system of State and national banks has been a positive element in the American system of government and has contributed to a more innovative and responsive financial system. Accordingly, maintaining a balance between the State and national banking systems is a desirable public policy. Nonetheless, we should not maintain a “balance” for the sake of balance. It is clear that Federal Reserve requirements bear heavily on member banks and result generally in such banks carrying more cash than they otherwise would.

One solution to the problem of equity that we believe should be resisted is the proposal to impose universal reserve requirements on the transactions balances of nonmember depository institutions. If nonmember banks have to maintain reserves at the Federal Reserve just as member banks must do, but have no access or have limited access to the discount window and other system benefits, why not become members? The assumption is that obligatory universal reserves would not only make nonmembership unattractive, but many institutions would also be inclined to convert to a national charter.

Indeed, even the payment of interest on and reduction of reserves might result in a massive influx into the State member and national systems. If this occurred, many State systems would lose their viability, and the Federal Reserve's and the Comptroller's supervisory authority would have grown substantially without the benefit of congressional consideration. My point is that the issue of Federal regulatory structure cannot be isolated from that of balance.

The impact of S. 3304 on the efficiency of the banking system also should be considered. Market pricing of goods and services is vital to their efficient allocation and use. Presently, pricing is absent in at least three areas that bear directly or indirectly upon the legislation under consideration: (1) the absence of interest payments on the required reserves of member banks, (2) the provision of services by the Federal Reserve to members banks, and (3) the prohibition of interest payments on demand deposit balances and deposit interest rate ceilings.

As a matter of principle, whether to pay interest on reserves should not be an issue. Presently, failure to pay interest is tantamount to the imposition of a tax on some of our banks without calling it that.
However, structuring a procedure for paying interest on reserves has raised difficult questions about the appropriate interest rate, concerns about possible windfall gains to large banks, and controversy over what percentage of the Federal Reserve System's revenues should be available for interest payments. It seems to me that a simpler approach would be to permit member banks to invest their reserves in interest-bearing securities. The Federal Reserve could determine what kinds of securities should be eligible for this purpose based on considerations such as risk. This approach would permit each bank to make its own choice and obviate the necessity of having the Federal Reserve establish a rate. This issue could be the subject of a study as Congressman Stanton has proposed in H.R. 12706.

Explicitly pricing Federal Reserve services should increase the efficiency of our financial system by allowing various financial institutions to purchase the services they desire either from the Federal Reserve or from private alternatives.

If interest were paid on member bank reserves, pricing of Federal Reserve services would be essential to prevent discriminatory treatment of nonmember depository institutions. Pricing would also provide a better opportunity for the correspondent banking system to compete with the Federal Reserve. Such competition, in turn, should encourage the Federal Reserve to eliminate waste, to improve services and to offer new ones.

Assuming that it is good public policy to maintain a significant presence for the Federal Reserve in the payments mechanism, we feel that the Federal Reserve should have some flexibility in setting prices. The requirement that pricing principles be produced and published at least a year before the fee schedule becomes effective assures that the Federal Reserve will not take advantage of its unique position. However, we would recommend that the matter of pricing guidelines receive careful study prior to the enactment of legislation on the issue of pricing to make sure that the Federal Reserve has pricing flexibility without unfair advantage.

Payment of interest on reserves of member banks potentially could place nonmember banks as a disadvantage because the 40-year-old prohibition against the payment of interest on demand deposits does not permit member banks to pay interest on correspondent balances. These balances often serve as reserves for nonmember banks and serve as well for check clearing operations and compensation for other correspondent services. If the principle of explicit pricing were adopted for member banks, then parallel treatment would dictate that correspondent banks should have the choice of paying interest on correspondent balances and levying explicit charges for correspondent services. There can be little doubt that this would increase the efficiency of the financial system.

However, if the interest prohibition is lifted for correspondent deposits, the principle of equity would dictate that it should be lifted for all demand deposits. I have long supported elimination of the prohibition of interest payments on demand deposits and rate ceilings on other kinds of deposits.

Finally, the last issue I would like to touch on concerns the discount window. The Federal Reserve believes that the ability of the system to cope with the kind of generalized liquidity crisis most of us are
concerned about—in which the public demands more cash than the banking system holds—aggressive open market operations and discount window accommodation to members can provide cash sufficient to meet the public’s demand.

The decline in membership does impair the ability of the system to minister to a localized liquidity squeeze involving one or a few institutions. In the past, the Federal Reserve has sometimes resorted to conduit loans for nonmembers in such circumstances—that is, loans to a member bank which in turn provides credit to a nonmember institution but has been reluctant to accommodate nonmembers directly through the discount window.

We believe that emergency borrowings from the Federal Reserve discount window should be available to member and nonmember banks alike upon certification by the FDIC that they are in danger of failing and that such assistance is necessary for a temporary period until a merger, a receivership sale or some other orderly resolution of the bank’s problems is arranged. The FDIC, in turn, should be authorized to guarantee the repayment of such borrowings out of the resources of the deposit insurance fund. In connection with this authority, the FDIC should be required by law to keep the Federal Reserve fully informed with up-to-date information as to the financial condition of all banks certified to borrow from the discount window under this provision.

The legislative proposals before the committee which address the issue of Federal Reserve membership attrition raise many of the other difficult issues we have been facing for the past decade. The persistent surfacing of these issues is a measure of the need to address them and resolve them, and I concede that the job of the Congress in this respect is not easy. I hope that these comments will prove to be helpful.

The CHAIRMAN. Thank you very much, Mr. LeMaistre.

STATEMENT OF GEORGE A. LE MAISTRE, CHAIRMAN, FEDERAL DEPOSIT INSURANCE CORPORATION

Mr. Chairman, I appreciate the opportunity to testify before this Committee and present the FDIC’s views on the Federal Reserve Requirements Act of 1978 (S. 3304) which would amend the Federal Reserve Act to provide for the maintenance of reserves by certain depository institutions, to require the Federal Reserve System to impose charges for its services, and to authorize the payment of interest on reserves held in Federal Reserve banks.

This bill and several under consideration by the House Committee on Banking, Finance, and Urban Affairs would deal with attrition in Federal Reserve System membership and related matters. There has been a slow but steady erosion of Federal Reserve membership over the last decade as banks have chosen to leave the System. Recently, this gradual decline accelerated. Since the beginning of 1977, 108 banks have withdrawn from membership. The percentage of total deposits of commercial banks held by Federal Reserve members has decreased from 83 percent in 1965 to nearly 73 percent at the present time.

The Federal Reserve System has become increasingly concerned about the attrition of membership and the declining proportion of deposits held by member banks. For many years it proposed mandatory membership as a solution. The proposal never received a serious hearing in the Congress for various reasons, primarily because of the concern expressed by the States about the impact of mandatory membership on the viability of State banking systems. More recently, the Federal Reserve modified its proposal to provide for mandatory reserves and membership privileges for nonmembers.

Last year, as the problem of membership attrition became more acute, the System proposed payment of interest on required reserves and reductions in
the minimum statutory reserve requirement limitations. Those proposals were coupled with the Consumer Financial Services Act S. 2065) which would have authorized depository institutions to offer NOW accounts. In my testimony on this subject before the Subcommittee on Financial Institutions last year, I stated that payment of interest on required reserves and reduction of reserve requirements would have important implications for the competitive balance between member and nonmember banks and for the structure of the banking system. I indicated that, in my judgment, these issues are quite complex and are not related to permitting interest bearing NOW accounts on a national basis. Therefore, I recommended that these issues be dealt with separately and be subjected to careful and reasoned study. These hearings and those recently held before the House Committee on Banking, Finance and Urban Affairs provide the opportunity for the thorough consideration I think is essential.

Let me begin by stating our view that the legal requirement that Federal Reserve member banks maintain sterile reserves is inequitable to them and inequitable to their customers. In many States, it also places member banks at a competitive disadvantage vis-a-vis nonmember banks. The bill under discussion proposes: (1) to establish universal reserve requirements for all banks or depository institutions; (2) to pay interest on reserves and to reduce reserve requirements; and (3) to charge banks for Federal Reserve services now provided free to member banks.

For reasons I shall discuss, we strongly oppose the establishment of universal reserve requirements for all commercial banks as well as all depository institutions. The payment of interest on reserves and pricing of services, however, are attractive and deserve thoughtful and sympathetic consideration. The implementation would not be easy because a redressing of the imbalance between member and nonmember banks raises many of the difficult issues with which the Congress has been wrestling, without resolution, for a number of years. These include, notably the issue of changes in the Federal regulatory structure, particularly whether the Federal Reserve should continue to exercise supervisory authority; and the issue to regulatory reform, particularly whether interest rate ceilings and the prohibition of interest on demand deposits should be abolished.

In the remainder of this statement I shall explain how we reached these conclusions by discussing how the proposals for dealing with the attrition of Federal Reserve membership bear on several important public policy considerations: (1) the capability of the Federal Reserve System to conduct monetary policy effectively, (2) the balance between the State and national banking systems, (3) the efficiency and innovative capacity of the banking system, and (4) the viability of the banking system under liquidity pressures.

I. MONETARY POLICY EFFECTIVENESS

The Federal Reserve has stated its belief that the decline in the proportion of deposits held by member banks caused by membership attrition adversely affects the precision with which monetary policy can be conducted. The point is that as a larger portion of deposits becomes subject to diverse State reserve requirements the linkage between bank reserves and the money supply becomes less predictable.

Of course, estimating the impact on the monetary aggregates of a particular change in reserves becomes more difficult when different banks are subject to different reserve requirements. But this problem would exist even if all banks were subject to universal reserve requirements or if all banks were member banks. Under the present reserve structure of the Federal Reserve, time deposits are subject to different requirements than demand deposits and different size classes of member banks are subject to varying reserve requirements. Hence, a shift of funds among member banks has precisely the same effect of blurring the precision of monetary policy that disturbs the Federal Reserve when nonmember depository institutions are involved. It should be noted that S. 3304 would not alter this appreciably, because it would maintain the present system of different percentages of deposits set aside as reserves based on bank size.

There have been several studies of the monetary control issue by economists outside the Federal Reserve. All of those that I am familiar with have concluded that increased Federal Reserve membership is not important to the effectiveness of monetary policy.

Two major statistical studies have attempted to ascertain the impact of universal reserve requirements for member and nonmember banks on the implementation of monetary policy. The first was conducted by Clark Warburton for
the Commission on Money and Credit. Warburton concluded that nonmember banks are affected by Federal Reserve monetary policy actions in approximately the same way that member banks are. Another investigation was reported by Dennis Starleaf of Iowa State University. In Starleaf's study the actual M₁ money multiplier for the period 1962–1972 was compared with a money multiplier series simulated under the assumption that all banks were subject to the reserve requirements of the Federal Reserve. The simulation indicated that had nonmember banks been subject to such reserve requirements there would have been even greater variations in the money stock. Starleaf thus rejected the argument that equal Federal Reserve reserve requirements for member and nonmember banks are necessary for the implementation of monetary policy.

There have also been a number of attempts to analyze the logical arguments and the statistical data that exist on this issue. The Hunt Commission concluded that "reserve requirements are unnecessary for open market operations to control the monetary base effectively." Carter Golembe, after discussing the difficulties in conducting monetary policy with precision, concluded that,

... So many factors contribute to the lack of precision and certainty that simply changing the proportion of deposits subject to Federal Reserve requirements from almost 80 percent to nearly 100 percent would be of relatively minor importance.

In a 1974 study, Professors Ross Robertson and Almarin Phillips investigated the argument that nonmember banks behave in a different manner from member banks and that such behavior thwarts implementation of Federal Reserve monetary policy. They concluded that these arguments have no validity. A study conducted by Gary Gilbert and Manferd Peterson at the FDIC found results similar to those of Robertson and Phillips.

Most economists regard reserve requirements as secondary to open market operations in conducting monetary policy. The Federal Reserve has made minimal use of changes in reserve requirements in recent years, possibly owing to its fear of aggravating the membership attrition problem. Nonetheless, the limited use of this monetary tool has not had a noticeable impact on the ability of the Federal Reserve to conduct monetary policy.

Furthermore, several studies have shown that open market operations have a timely impact on all commercial bank reserves. These studies indicate that the total impact is felt by banks in some regions within the first 2 weeks following open market operations. In most cases, the impact of open market operations on reserves is completely transmitted within 6 weeks. Moreover, the length of time for the impact of open market operations to be transmitted is not related to the region's distance from money market centers.

What the Federal Reserve does need to conduct monetary policy effectively is information about monetary aggregates. For the conduct of monetary policy, the Federal Reserve should be permitted to obtain summary statistics on assets and liabilities of all depository institutions from the appropriate Federal agency. S. 3304 would require depository institutions to report their deposit liabilities and required reserves directly to the Federal Reserve. We support making such information available to the Federal Reserve and have no objection to the adoption of the proposal in S. 3304.

Several years ago, the Federal Reserve became concerned about the adequacy of its data on the money supply and established a committee chaired by Professor George L. Bach of Stanford University to recommend changes in money supply statistics. One of the major recommendations of the Bach Committee was that better and more frequent data on nonmember bank deposits were desirable. Following that report, the FDIC instituted a special schedule in the quarterly call report for all nonmember banks to provide the Federal Reserve with better information on the money supply. This schedule requires nonmember banks to compute a 7-day average of deposits for the 7 days ending with the date of call. This collection was initiated with the spring 1976 Call for Reports of Condition.

A second step, also recommended by the Bach Committee, went into effect in the first week of July 1977. A sample of 580 nonmember banks is reporting deposit and cash items on a regular weekly, basis, the same items as all nonmember banks report four times a year. The Federal Reserve has indicated that it expects the data from these two surveys to permit significant improvements in their estimates of the nonmember bank component of the Nation's money supply. The FDIC and the Federal Reserve have agreed to review this program in mid-1979 to determine whether nonmember bank data are necessary
for monetary policy purposes and, if they are, whether the sample of nonmember banks is adequate. In the interest of improving the timeliness of the survey data to the Federal Reserve, the FDIC intends to request the 580 banks participating in the program to submit the data directly to the Federal Reserve rather than through the FDIC regional offices, which is the present procedure.

In summary, we believe the need for legal reserve requirements for monetary control purposes is not supported by the weight of available evidence. The evidence to date suggests that monetary policy effectiveness depends on adequate data, proper estimation procedures, and appropriate open market operations decisions; and not on reserve requirement jurisdiction.

**Bank supervision and the exercise of monetary policy**

Representatives of the Federal Reserve System have also argued that significant supervisory and regulatory responsibilities are required for the effective conduct of monetary policy. In his testimony before the House Banking Committee, Chairman Miller reiterated the Federal Reserve’s belief that its activities in the bank supervisory and regulatory area “cannot be readily separated from its job of conducting monetary policy.” In the past, representatives of the Federal Reserve have argued as well that an understanding of the nuances of monetary policy and of developments in the economy facilitate bank supervision.

We feel there are two valid arguments why bank supervision and regulation and the conduct of monetary policy should be separated. First, it has been argued that the Federal Reserve’s responsibility for bank supervision diverts attention from monetary policy formation and that this diversion may reduce its effectiveness in implementing monetary policy. Second, when the implementation of monetary policy goals and bank supervision are combined, the former will inevitably take precedence leading to inconsistent and inequitable bank supervision.

We believe some benefits will be gained from the functional separation of supervision and monetary policy. Furthermore, it is our opinion that the attrition of members from the Federal Reserve System and, hence, a lessening of its supervisory and regulatory presence has not interfered with the effective conduct of monetary policy. Based on the available evidence and experience, we tentatively conclude that neither control of reserve requirements in nonmember depository institutions nor supervisory jurisdiction is critical to the conduct of monetary policy.

**II. Dual Banking System**

Historically, our Nation’s banking system has developed within the unique Federal character of our State and national governments. Today this is manifested in the ability of both the States and the Federal Government to charter banks and other kinds of depository institutions. The vitality of this dualism is maintained by permitting banks to convert from one chartering authority to another.

While some may disagree, we believe the dual system of State and national banks has been a positive element in the American system of government and has contributed to a more innovative and responsive financial system. Accordingly, maintaining a balance between the State and national banking systems is a desirable public policy. The attrition in Federal Reserve membership gives some credence to the argument that this balance is tilting toward the State systems. However, despite the decline of Federal Reserve membership, member banks still hold about three-quarters of domestic deposits. Moreover, the largest banks which depend on Federal Reserve clearing and money transfer services represent a hard core of membership and deposits not likely to leave the system.

Nonetheless, we should not maintain a “balance” for the sake of balance. It is clear that reserve requirements of the Federal Reserve weigh heavily on member banks and result generally in such banks carrying more cash than they otherwise would. In direct competition with the nonmember bank, a member bank might be disadvantaged.

One solution to the problem of equity that we believe should be resisted is the proposal in S. 3304 to impose universal reserve requirements on the transactions balances of nonmember depository institutions. As we explained above, extension of universal reserve requirements to nonmember institutions is not essential to conduct monetary policy effectively. While reserve requirements are primarily responsible for the inequity of Federal Reserve membership, we believe that equity can be achieved in other ways—such as paying interest on re-
serves, permitting reserves to be held in the form of marketable securities, or reducing reserve requirements—without the necessity of resorting to universal reserves for all institutions.

Universal reserve requirements are perceived as a threat to the integrity of State banking systems. If nonmember banks have to maintain reserves at the Federal Reserve just as member banks must do, but have no access or have limited access to the discount window and other System benefits, why not become members? The assumption is that obligatory universal reserves would not only make nonmembership unattractive, but many institutions would also be inclined to convert to a national charter. The result would be an imbalance in the dual system in favor of membership and the national banking system.

We do not know whether this would occur. However, such a proposal should not be accepted unless this danger is eliminated. If there were a massive influx into the State member and national systems, many State systems would lose their viability, and the supervisory authority of the Federal Reserve and the Comptroller of the Currency would grow substantially without the benefit of Congressional consideration. My point is that the issue of Federal regulatory structure cannot be isolated from this issue of balance. The better of the two proposals—the payment of interest on reserves and lowering of reserve requirements—would have some serious shortcomings of the universal reserve requirements proposal, but it raises the possibility of weakening the State systems.

In summary, we cannot prove that universal reserve requirements would seriously damage the dual banking system. However, we feel this portion of S. 3304 should be eliminated unless sufficient safeguards for maintaining a balance in the dual banking system are developed.

III. BANKING SYSTEM EFFICIENCY AND INNOVATIVENESS

Market pricing of goods and services is vital to the efficient allocation and use of those goods and services. In the words of Milton Friedman, pricing is highly desirable “... to prevent the waste that arises from the absence of specific charges for them.” Generally, market pricing encourages competition to improve the quality of goods and services and to lower their cost. Presently, pricing is absent in at least three areas that bear directly or indirectly upon the legislation under consideration: (1) the absence of interest payment on the required reserves of member banks, (2) the provision of services by the Federal Reserve to member banks, and (3) the prohibition of interest payments on demand deposit balances and deposit interest rate ceilings. I will address each in turn.

Interest on reserves

As a matter of principle, whether to pay interest on reserves should not be an issue. Presently, failure to pay interest is tantamount to the imposition of a tax without calling it that. A substantial amount of the revenue foregoing by member banks is passed on to the Treasury Department by the Federal Reserve. Some of the revenue is used by the System to offset the cost of providing “free” services to member banks. If it were the national policy to tax banks, it would be preferable to levy the tax directly on all banks and other depository institutions as well. Then all would be treated equally.

Concern has been raised about the adverse impact payment of interest on reserves would have on Treasury revenues. This concern has led to attempts to structure a procedure for paying interest while minimizing the loss in Treasury revenues. However, structuring a procedure for paying interest bogs down in questions about the appropriate interest rate, concerns about possible windfall gains to large banks, and controversy over what percentage of the Federal Reserve System’s revenues should be available for interest payments. We submit that none of this is really necessary. It imposes the subjective judgment of men in dealing with the cost of membership when the market system could probably do better. Why not permit member banks to invest their reserves in interest bearing securities? In fact the percentage of assets held in cash would probably be reduced by only a few percentage points. The Federal Reserve could determine what kinds of securities should be eligible for this purpose based on considerations such as risk. It might even supply them from its portfolio. This approach would permit each bank to make its own choice and obviate the necessity of hav-
ing the Federal Reserve establish a rate. Presumably, 36 States allow State nonmember banks to hold at least part of their required reserves in the form of U.S. Government securities. This issue should be the subject of a careful study as Congressman Stanton has proposed in H.R. 12706. If either the loss of Treasury revenues or subsidization of small banks were felt to be important problems, we would recommend that the Congress address these problems directly through national tax policy.

To the extent that our faith in the efficacy of the market system might be misplaced, we endorse the provision in Section 3 of H.R. 12706 that would require the Board of Governors to prepare a study on permitting member banks to invest their reserves in securities.

**Pricing of services**

Explicitly pricing Federal Reserve services should increase the efficiency of our financial system by allowing various financial institutions to purchase the services they desire from the Federal Reserve or private alternatives. Among the Federal Reserve System’s major service are: operation of the payments system, including check processing and transportation and automated clearinghouse services; pickup and delivery of coin and currency; wire transfers; purchase, sale, safekeeping and clearing securities; and operation of the discount window.

If interest were paid on member bank reserves, by whatever means, pricing of Federal Reserve services would be essential to prevent discriminatory treatment of nonmember depository institutions. Pricing of services also is sound policy because it would enhance the efficiency of the financial system. This would provide a better opportunity for the correspondent banking system to compete with the Federal Reserve. Such competition, in turn, should encourage the Federal Reserve to eliminate waste, to improve services and to offer new ones.

Assuming that it is good public policy to maintain a significant presence for the Federal Reserve in the payments mechanism, we feel that the Federal Reserve should have some flexibility in setting prices. The requirement that pricing principles be produced and published at least a year before the fee schedule becomes effective assures that the Federal Reserve will not take advantage of its unique position. In developing a set of principles, we would hope that consideration would be given to some of the following matters so that further Congressional action will not be necessary.

The costs of producing the same service for a variety of customers may differ in various areas of the country because labor and capital costs are not equal. Thus, it may be more efficient for the Federal Reserve to charge different prices according to the costs of providing services to different customers. The cost of providing a certain service to nonmember banks and nonbank depository institutions could be below the cost of providing the same service only to member banks. This could result from the way in which a service were utilized. For example, a credit union may not require daily pickup and delivery of coins or currency, or a savings and loan association might not complete security transactions as often as a commercial bank.

To allow the Federal Reserve some flexibility in developing and implementing a pricing system, the Federal Reserve should be permitted to price services explicitly by broad service classes. One price schedule might be developed for payments services, another for securities services, and another for transportation. Perhaps a cost-plus pricing system could be developed for the services now provided by the Federal Reserve, and the markup over the cost of providing the service might be limited to a fixed percentage.

There seem to be economies of scale associated with at least some services that the Federal Reserve now provides. If these economies are pervasive, the Federal Reserve will be able to offer the relevant service at a lower price than any private competitor. There is nothing undesirable about this, but the result should be determined by experience, not flat. It is not unlikely that the Federal Reserve has a natural monopoly on some services because private competitors could not attract sufficient volume to offer the same services at as low a price.

According to materials that former Federal Reserve Chairman Burns submitted to Senator Proxmire on October 4, 1977, in recent years the per unit costs of conventional check processing, return items, transfer of funds, and automated clearinghouse activities have declined as volumes increased. If these trends continue, the private sector might not be able to offer competing services at costs
that are as low as those incurred by the Federal Reserve. On the other hand, the cash services offered by the Federal Reserve do not seem to show declining costs with increasing volumes. In an electronic banking environment, it is not clear that several payments systems can compete efficiently. However, in this regard we point out that the private bank wire continues to compete with the Federal Reserve wire, and networks of correspondent banks provide payment services that are preferred by some member banks over Federal Reserve payment services.

**Interest on demand deposits**

Payment of interest on reserves of member banks potentially could place non-member banks at a disadvantage because the 40-year old prohibition against the payment of interest on demand deposits does not permit member banks to pay interest on correspondent balances. These balances often serve as reserves for nonmember banks and serve as well for check clearing operations and compensation for other correspondent services. If the principle of explicit pricing is adopted for member banks, then parallel treatment would dictate that banks should have the choice of paying interest on correspondent balances and levying explicit charges for correspondent services. There can be little doubt that this would increase the efficiency of the financial system.

As a matter of principle, if the interest prohibition is lifted for correspondent deposits, it should be lifted for all demand deposits. I have long supported elimination of the prohibition of interest payments on all transactions balances as well as removal of interest rate ceilings on other kinds of deposits. Economists have demonstrated that there is no merit to the contention that competition for demand deposits through the payment of interest led to bank failures during the Depression as some contend. They have also demonstrated, at least to our satisfaction, that competition for deposits through the pricing mechanism would result in a more efficient allocation of resources than competition through indirect means involving the implicit payment of interest by building more branches, keeping open longer hours, providing free checking services, offering premiums and free travelers' checks, as well as a variety of other services. Such competition would lead to substantial benefits for both financial institutions and bank customers.

Under the present system of implicit interest payments on checking accounts, depositors are denied the opportunity to determine for themselves how they wish to spend their portion of the income the bank earns on their deposits. If interest were paid, a depositor might choose to consume the same services that banks now offer in the course of competing with other institutions for accounts or a depositor might choose to forego such services and spend interest income on different goods and services. This is an important benefit—consumers would decide how to spend their interest income, not the banks.

Free- or below-actual-cost checking encourages inefficient use of resources because depositors have little or no incentive to economize on check writing, even though check clearance costs are substantial. Direct charges for checks are likely to prompt depositors to write fewer checks. Such fees should cover a substantial cost of clearing checks. Management’s adoption of pricing policies more nearly in line with the costs of providing services to customers will enhance a financial institution’s capability of paying a competitive interest rate on deposit balances without impairing earnings.

Payment of competitive interest rates will lower some operating costs by reducing the need for customers to transfer funds from noninterest bearing checking accounts to savings accounts. Thus depositors will no longer find it necessary to maintain separate checking and savings accounts. Customers will not need to spend as much time and effort in managing deposit balances, particularly when interest rates are high. Also, existing inequities whereby some depositors pay less than the cost of servicing their accounts will be eliminated.

**IV. Banking system viability and liquidity pressures**

One of the important functions of the Federal Reserve System is to serve as the Nation’s lender of last resort. Through the vehicle of the discount window, the Federal Reserve is able to provide liquidity when it is needed. The discount window acts as a safety valve by permitting the Federal Reserve to cushion the
impact of a tight monetary policy on individual institutions. It can also assist member banks in meeting routine but unexpected loan demand or deposit withdrawals, seasonal liquidity requirements, and emergency liquidity needs. A member bank's first recourse is expected to be to the market. If sufficient funds are not available in the market, the Reserve Bank might provide accommodation, but it is understood that it is temporary. Each member bank must eliminate its discount window borrowings within a reasonable period. Reserve Banks also require member banks to pledge collateral, typically of high quality.

The Federal Reserve Act authorizes entities other than member banks to use the discount window only under "unusual and exigent" circumstances. As a result, Federal Reserve reports indicate that no nonmember bank has borrowed from the discount window since 1966.

While nonmember banks also face unexpected needs for liquidity, they ordinarily cope with them with little difficulty by borrowing from correspondent banks in much the same way that members do from the Federal Reserve. Indeed, even when nonmember banks are in trouble, it is generally possible for them to borrow from correspondents if they have sufficient and acceptable collateral. To be sure, the lending bank may also impose special conditions on the borrowing bank. But in that regard, the Federal Reserve also behaves like a careful creditor in accommodating a floundering bank. It makes sure such loans are well collateralized, that its interest in the collateral is perfected, and that the borrowing bank is solvent. Thus, the fact that nonmembers do not have window accommodation is not seriously disadvantageous in most circumstances.

The Federal Reserve believes that the ability of the financial system to handle liquidity "crunches" will weaken if membership attrition continues unabated. It should be understood that the decline in Federal Reserve membership does not impair the ability of the System to cope with the kind of generalized liquidity crisis most of us are concerned about, in which the public demands more cash than the banking system holds. Aggressive open market operations and discount window accommodation to members can provide cash sufficient to meet the public's demand. The decline in membership does impair the ability of the system to minister to a localized liquidity squeeze involving one or a few institutions. In the past, the Federal Reserve has sometimes resorted to conduit loans in such circumstances—that is, loans to a member bank which in turn provide credit to a nonmember institution. We think that the Federal Reserve should accommodate a nonmember bank directly in such special circumstances.

Indeed, we are concerned that membership attrition has contributed to a narrow interpretation of the words "unusual and exigent" by the Federal Reserve. If experience is a guide, these words appear to be interpreted by the Board of Governors as requiring a national emergency before a Reserve Bank would be authorized to lend to a nonmember institution. The interpretation could be less restrictive, but at the present time it does not appear that the Board of Governors is willing to interpret "unusual and exigent" circumstances as extending to situations that are unique to an individual nonmember institution. The unwillingness of the Federal Reserve to open the discount window to American Bank and Trust of Orangeburg, South Carolina, in September 1974 led to the FDIC to take the unusual step of providing short-term liquidity directly to the bank under Section 13(c) of the FDI Act. The Federal Reserve make short-term, temporary loans available to nonmember banks in such circumstances. We support Chairman Wille's proposal. We believe that emergency borrowings from the Federal Reserve discount window should be available to member and nonmember banks alike upon certification by the FDIC that they are in danger of failing and that such assistance is necessary for a temporary period until a merger, a receivership sale, or some other orderly resolution of the bank's problems is arranged. The FDIC, in turn, should be authorized to guarantee the repayment of such borrowings out of the resources of the deposit insurance fund. In connection with this authority, the FDIC should be required by law to keep the Federal Reserve fully informed with up-to-date information as to the financial condition of all banks certified to borrow from the discount window under this provision.

The Chairman. Mr. Connell.

1 Two weeks later the bank was closed.
STATEMENT OF LAWRENCE CONNELL, ADMINISTRATOR, NATIONAL CREDIT UNION ADMINISTRATION

Mr. CONNELL. Mr. Chairman, members of the committee, I welcome the opportunity to appear here this morning and present the views of the National Credit Union Administration on S. 3304, the Federal Reserve Requirements Act of 1978. This legislation, if properly modified, would strengthen the Federal Reserve System, equalize the terms on which depository institutions compete, and assure an orderly development of future payments mechanisms.

My remarks will be primarily directed toward those provisions in the legislation which have application directly or indirectly to credit unions. I would also offer some personal observations regarding the proposal and its possible effects on the Federal Reserve System in monetary policy implementation and payment system operations.

For the most part, the Federal Reserve membership problem appears to be caused by smaller banks ending their member relationship with the System. As this increases the number of commercial banks outside the Federal Reserve System, a number of undesirable effects take place.

The first is clear—the Nation’s central bank loses contact with smaller communities in our country and thusly loses the benefit of input from these communities. The foundations of the payments mechanism are also weakened.

Some of the early thinking regarding the Federal Reserve System incorporated a federation of clearinghouses whose liabilities were guaranteed by the United States. From the foundation of the Nation’s central bank, the Federal Reserve has—since the second decade of this century—provided the base for an acceptable payments mechanism performance level which has been a public good of inestimable value to American economic development.

I am not suggesting that clearing services should be provided primarily by the Federal Reserve. In fact, the prospect of service unbundling and explicit prices opens the way for assuring sound development of private electronic and paper funds transfer systems. I believe the private sector will, in the coming years, become increasingly the predominant component of the payments system. This development, however, will not be sound if the Federal Reserve is unable to assure an acceptable level of payments system performance in every region and community in this country. There may be some areas in which private sector systems cannot be operated profitably.

Another undesirable effect of the decline of the Federal Reserve membership is a return to the practice of pyramiding reserves in banks of increasing size and proximity to money markets. Before the Federal Reserve was established, banks maintained liquidity with hard currency and deposits in larger banks. These larger regional banks, in turn, held liquidity in the form of the liabilities of even larger money-center banks. When one of the money-center banks failed, it took with it some of the smaller banks that were depending on it. The more banks there are outside the Federal Reserve, the greater will be the extent of liquidity pyramidning. It was an unsafe practice in the 1800’s, and it still is.
A fourth unwanted effect of declining Federal Reserve membership is a decline in the efficiency of the lender of last-resort function. With member institutions in every community, there is a mechanism for making funds available to a bank or nonbank institution which is based on a financial intermediary familiar with the Federal Reserve and its procedures. As Federal Reserve membership erodes and community representation becomes minimal, the providing of liquidity to nonmoney market areas becomes steadily more difficult and less efficient.

In summary, the decline in Federal Reserve membership brings with it a number of unintended results.

One. It results in the central bank primarily serving the larger commercial banks, and it is perceived by the local community as a representative of the larger banks rather than serving a broad spectrum of the community;

Two. It undermines the foundation of the payments system and restricts payments system developments to the large bank members;

Three. It encourages a return to liquidity pyramiding; and

Four. It reduces the Federal Reserve's ability to serve as the lender of last resort.

Nationwide reserve requirements on all depository institutions offering third-party payment services, coupled with interest payments on reserves, unbundled services, and explicit pricing would prevent the unintended effects of membership declines from taking place.

Mr. Chairman, I believe that a further benefit is likely to occur with the establishment of uniform reserves; namely, an increase in the monetary control capability of the Federal Reserve Board.

Accurate control of the money supply requires among other things that the Federal Reserve know how many dollars of demand deposits are likely to be created for each dollar added to the system through open market operations. The imposition of uniform reserves in conjunction with these open market operations can be viewed with respect to its effect on monetary control. I recognize that strong economic arguments have been presented on both sides of this issue. My personal experience leads me to believe that monetary control will be improved by the imposition of these reserves. Additionally, I am persuaded by the fact that the Federal Reserve itself is requesting this as a necessary element in future monetary control operations.

In addition to possibly improving the Federal Reserve's ability to control the money supply, uniform reserve requirements would broaden the membership base of the central bank to include virtually every depository institution in the country. If the broader membership base were coupled with changes in the selection and tenure of Federal Reserve Bank directors and Board members—proposals this committee and its House counterpart have considered before—the leadership of the Federal Reserve would become more representative of its newly expanded base and of the economy as a whole. The Federal Reserve has already taken tentative steps in this direction.

As for credit unions, I believe those that offer transactions accounts should be subject to the same reserve requirements and monetary policy reporting requirements imposed on banks and other third-party paying thrift institutions. I feel strongly, however, that in-
formation on credit unions should be provided by the National Credit Union Administration. This legislation provides that the Federal Home Loan Bank System would receive and hold the required reserves of savings and loan associations. Similarly, I feel the National Credit Union Administration through a central liquidity facility should be specified as the receiver and holder of credit union reserves.

The share draft accounts of federally chartered credit unions totaled only $588 million as of June 30, 1978. Of that amount, $212 million was held in the 19 credit unions which currently have share draft accounts totaling more than $5 million. If uniform reserves were imposed as the legislation provides, federally chartered credit unions would have to set aside $25.4 million to meet the maximum requirement.

Credit unions are becoming increasingly involved in the Nation's developing payments mechanism. The explicit pricing proposal is timely and necessary. It will strike a balance between the vast network which the Federal Reserve currently has in place and the multitude of private institutions which have come forth on the wave of the new electronic technology.

Private initiatives will insure the Federal Reserve System runs with maximum efficiency, taking advantage of in-place components of the system which continue to be useful. The in-place system will assure an acceptable level of payments system performance to every consumer and even in the remote sections of the country.

I recognize that we must face the problem of access to Federal Reserve services by nonmember financial institutions. I feel the direct access approach should be followed with some form of compensation for the stock purchases required of member banks. I will be looking forward to the Board's pricing recommendations which are scheduled to be presented later this month.

The following comments are directed at specific sections of the bill. Section 103(4) provides for an exemption for financial institutions with transaction accounts of $5 million or less. It further provides that this exemption may be waived by the Board under certain conditions. My concern here is to insure that any imposition of reserve requirements on this group of smaller institutions not be done in a sudden or precipitous manner.

Section 103(5) would require a credit union to make reports concerning its deposit liabilities to the Board. As I mentioned previously, I feel strongly that this information should be supplied to the Board by the National Credit Union Administration.

Mr. Chairman, this concludes my testimony. I will be happy to answer any questions you might have.

The CHAIRMAN. Thank you very much, Mr. Connell.

Dr. Biederman.
STATEMENT OF DR. KENNETH BIEDERMAN, DIRECTOR, OFFICE OF ECONOMIC RESEARCH, FEDERAL HOME LOAN BANK BOARD

TESTIMONY ON S.3304
FEDERAL RESERVE REQUIREMENTS ACT OF 1978

By
Kenneth R. Biederman
Director, Office of Economic Research
Federal Home Loan Bank Board

SUMMARY OF BANK BOARD'S POSITION
The Bank Board does not believe that reserve requirements should be made compulsory for thrift institutions on their transaction accounts. To the extent that reserves are required for S&Ls, in connection with any nationwide extension of NOW accounts, such reserves should be held at Federal Home Loan Banks, and the Bank Board should play a more defined role in setting such reserve requirements.

The Bank Board believes that a better procedure than requiring reserves is for Congress to consider permitting the explicit payment of interest on reserves so as to induce broader membership in the Federal Reserve System on the part of commercial banks.

Finally, the Bank Board holds that the payment of such explicit interest can be justified on broader economic grounds. It would make more feasible the pricing of Federal Reserve services and direct access to such services by thrift institutions, a position that we strongly endorse. The Bank Board would recommend, however, that the bill require pricing based on comparability with the private sector.
Mr. Chairman and Members of the Committee, my name is Kenneth Biederman. I am Director of the Office of Economic Research at the Federal Home Loan Bank Board. The Bank Board appreciates this opportunity to present its views on S.3304.

This bill contains three proposals. The first would require savings and loan associations, mutual savings banks, credit unions, and all commercial banks to hold reserves against transaction accounts. Reserve requirements for all depository institutions would be determined within prescribed statutory limits by the Federal Reserve Board.

Second, the bill would authorize the Federal Reserve System to pay interest on reserve balances.

Third, the bill would require the Federal Reserve Board to publish for public comment a set of pricing principles and a proposed schedule of fees for services that it provides, and to put fees for services into effect by a certain date. I would like to comment on each of these three proposals.

**RESERVE REQUIREMENTS FOR ALL DEPOSITORY INSTITUTIONS**

The Bank Board believes that requiring reserves to be held by all major types of depository institutions against their transaction accounts is an unnecessary step. By far the dominant volume of transaction accounts is held at commercial banks. Based on a definition that includes demand deposits, interest and non-interest bearing NOW accounts, and share draft accounts, commercial banks hold
99.2 percent of all transaction accounts, or about $256 billion. To the extent that the lack of control over reserves on transaction accounts presents a problem in executing monetary policy, this results almost entirely from the fact that State-chartered commercial banks have the option of not belonging to the Federal Reserve System. These non-member banks have 30.5 percent of transaction accounts, compared to .8 of 1 percent held at thrift institutions.

In terms of quantitative magnitude, the Bank Board sees little to be gained by the Federal Reserve having authority to impose and enforce reserve requirements for thrift institutions. The bill provides that the first $5 million of transaction accounts for each depository institution would not normally be subject to reserve requirements. A $5 million exemption would effectively eliminate reserve requirements for almost all savings and loan associations at this time.

However, the bill as drafted would permit the Federal Reserve Board to impose reserve requirements of up to an average of 7 percent on the first $5 million of transaction accounts if it determined this “to be appropriate in light of general liquidity, considerations of monetary policy, or other relevant conditions prevailing in the banking system.” The decision to do so would reside solely with the Federal Reserve Board. This part of the bill creates an ambiguity as to how extensive would be the imposition of reserve requirements on S&Ls.

If and when S&Ls receive checking and NOW accounts nationally, and assuming that reserves could be held at the Federal Home Loan Banks, the Bank Board would agree that there is a need to consider the imposition
of reserves on S&Ls. The Bank Board's important role in moderating the excessive impact of monetary policy on housing credit implies that any reserves eventually required of S&Ls be held at the Federal Home Loan Banks and be determined by housing credit considerations as well as considerations of general monetary policy. Indeed, such reserves could, depending on future developments in this area, serve as a source of loanable funds to implement housing goals.

There appear to be two arguments that underlie the proposal for extending reserve requirements to all major depository institutions. The first has to do with the impact on the effectiveness of monetary policy; in particular, the control over monetary aggregates. The second has to do with competitive parity because of the alleged unfairness of reserve requirements imposed only on member commercial banks, and not on non-member commercial banks and other types of depository institutions.

With respect to the effectiveness of monetary policy, the Bank Board recognizes that the Federal Reserve's viewpoint on this matter must be given significant weight since it has the responsibility for the implementation of monetary policy. However, the Bank Board is aware of differing points of view on the need for required reserves.

There is a body of opinion among some monetary economists that required reserves are not necessary to permit Federal Reserve open market operations to be an effective tool for controlling the money supply. There are many monetary economists who believe that considerably less than all transaction accounts need to be covered by reserve requirements in order for open market operations to be able to meet monetary growth targets set by the Federal Reserve System. Even among those who argue for the need for required reserves, there is no consensus on what the level
of reserve requirements should be and, in particular, whether it needs to be as high as the upper limit of the ranges within which this bill would establish such requirements.

What is essential for an effective monetary policy is for the Federal Reserve to have better information about transaction and other deposits of non-member depository institutions, and the Bank Board stands ready to provide the Federal Reserve with timely data on deposits of S&Ls.

To the extent that the Federal Reserve Board feels strongly that the erosion of its membership base is a significant deterrent to effective monetary policy, a promising approach, in our opinion, is provided in Title III of this bill that would give the Federal Reserve Board authority to pay interest on reserves. This would hopefully be adequate to prevent further erosion in the membership base of the Federal Reserve System, and perhaps cause some non-member banks to convert to membership status.

It needs to be emphasized that S&L savings flows are very much affected by Federal Reserve monetary policy actions, even though S&Ls are not currently subject to reserve requirements. The instability in savings flows has been demonstrated in many studies and was documented in Chairman McKinney's testimony on the conduct of monetary policy before the House Banking Committee on August 7.

As we have seen since 1966, Federal Reserve actions that push up interest rates make it less advantageous for households and others to hold savings accounts at S&Ls. The result is a sharp reduction in savings flows at S&Ls that normally gets translated into a comparable reduction in mortgage lending and housing. Thus, monetary policy has
had a major impact on mortgage credit and on housing. This was brought out in Charts 1-4 that Chairman McKinney presented in his testimony noted above, which are attached to this presentation for reference.

In fact, Federal Reserve monetary policy actions cause a larger adverse impact on deposits at S&Ls and mutual savings banks than they do on deposits at commercial banks. This is illustrated by data that show that the deposit growth rate for S&Ls slowed from 17.3 percent during mid-1976 to mid-1977, to 12.3 percent during mid-1977 to mid-1978. In contrast, total deposit growth of commercial banks rose from 9.1 percent to 10.7 percent during the same periods. The fact is that monetary policy actions result in much greater instability in savings flows than in transaction accounts, since households and others have a wide variety of options with respect to savings media, many of which are not in deposit form.

With respect to transaction accounts, however, there is little in the way of options other than deposits, so that such accounts show much less interest rate sensitivity. Thus, the facts would indicate that there is no need for reserve requirements against any types of accounts held at S&Ls in order for monetary policy to affect deposits and mortgage lending at such institutions. As demonstrated above, thrift institutions and mortgage markets already bear a relatively heavy burden of the impact of monetary policy, and the Bank Board's major role has been to soften and to diffuse the impact of monetary policy more equitably.

The Bank Board submits that this bill ignores a development that could have more far reaching implications than the limited volume of transaction accounts that are held by thrift institutions. This is
the Federal Reserve and FDIC's regulation that would permit the automatic transfer of funds from savings accounts to checking accounts of banks, with no required fees, effective November 1. If and when this goes into effect, it would convert a large proportion of savings accounts of banks into the equivalent of checking accounts.

There is nothing in this bill that would mandate the Federal Reserve Board to require savings accounts linked to checking accounts through the automatic transfer provision to bear reserve requirements equal to that of checking accounts, or even to require that they bear reserve requirements equal to that on transaction accounts other than checking accounts. The same applies to other third party transfers, such as telephone bill paying services. It is our position that any bill reported out should contain such provisions.

This brings us to the second argument that appears to be the basis for the proposal that reserve requirements be imposed on transaction accounts at all major depository institutions: The matter of equity and competitive parity. The argument is made here that, even with the payment of interest on reserves, the interest payments permitted under this bill would be below alternative rates on other assets. Thus, it would seem the Federal Reserve is arguing that fairness requires that all depository institutions be subject to the same drag on earnings as member commercial banks currently subject to the Fed's reserve requirements.

In the Bank Board's opinion, this is not a tenable argument. In order to assess properly the equity-competitive arguments, one has to look at the totality of constraints imposed on thrift institutions relative to commercial banks. In the case of savings and loan
associations, they are already subject to liquidity requirements which, by statute, must range between 4 to 10 percent. The purpose of such liquidity requirements is to provide the Bank Board with a policy tool to affect mortgage credit availability.

There are no similar liquidity requirements imposed by the Federal Reserve Board upon commercial banks. While these liquidity requirements can be met through interest earning liquid assets, the return on such assets is normally significantly less than that on mortgage loans. In 1977, for example, the average yield on liquid assets of S&Ls was somewhat under 7 percent compared to an average yield of 8.2 percent on the mortgage portfolio. If liquidity requirements were abolished and liquid assets put into mortgage loans at their current rate of 9-1/2 to 10 percent, the result would be to add about $500 million to S&L earnings, or about 15% of earnings in 1977. Thus, S&Ls are already subject to a drag on earnings from the need to hold liquidity requirements.

Liquidity requirements are only one part of the broader question of competitive parity between S&Ls and commercial banks. The fact is that S&Ls still generally have asset and liability powers that fall considerably short of those of commercial banks. This gives commercial banks a definite edge in the competition for deposits since they can provide a complete range of financial services under one roof. One study has shown that competitive parity would require up to a 3/4 of 1 percent interest rate differential in favor of S&Ls relative to that of commercial banks.

In addition, S&Ls also have a significantly higher average tax rate than commercial bank competitors because of the greater ability of commercial banks to take advantage of various tax shelters.
Thus, the Bank Board can see no justification for reserve requirements being imposed on S&Ls from the standpoint of the competitive argument at this time. To impose such requirements would not bring about competitive parity as appears to be implied by proponents of such requirements. On the contrary, it would further aggravate the competitive imbalance between S&Ls and commercial banks.

The Bank Board is also troubled by the degree of control of the Federal Reserve Board under this proposal, and this appears to go well beyond what is necessary for an effective monetary policy. Under S.3304, the Federal Reserve would have sole authority to determine whether a deposit may be considered a transaction account. The Federal Reserve would only be required to consult with certain other Federal financial regulatory agencies when making this decision. Since an increasing proportion of savings accounts of S&Ls, as well as commercial banks, are likely to be subject to preauthorized payments, telephone bill paying services, debit cards, or other types of access, this will give the Federal Reserve the latitude to include a large proportion of savings accounts as transaction accounts, even though the volume of transaction debits through such accounts may remain well below that of checking or NOW accounts.

S. 3304 provides no guidelines for the Federal Reserve with respect to the degree of transaction activity that needs to be exhibited in savings and time accounts for these to be classified as transaction accounts. The Bank Board has no way of knowing to what extent the Federal Reserve's power to define transaction accounts would provide a backdoor means to impose reserve requirements on savings accounts of S&Ls.
In addition, within the ranges set in this bill, the Federal Reserve Board would have sole authority to determine reserves against demand and other transaction accounts of thrift institutions. Reserves against demand deposits could be set anywhere between 7 and 22 percent, while reserves against all other transaction accounts could be set between 3 and 12 percent. This means that the level of reserve requirements would be determined entirely by considerations that appear paramount to the Federal Reserve Board. The level of reserve requirements imposed on S&Ls would not have to reflect, for example, concerns of the Bank Board about mortgage credit availability and housing activity, or the impact that such reserve requirements might have on the earnings position and viability of thrift institutions.

An important provision of this bill is that the portion of required reserves not held in the form of vault cash by S&Ls would have to be deposited ultimately in a Federal Reserve Bank. A member commercial bank or a Federal Home Loan Bank could only be a conduit through which reserves required of an S&L are funneled to a Federal Reserve Bank.
Bank. The Bank Board is quite concerned about this provision of the bill, which is paralleled in a bill (S.2055) reported by this Committee which would authorize NOW accounts nationally for thrift institutions and commercial banks.

To repeat ourselves, we are concerned about the substantial power that the Federal Reserve Board would have under this bill with respect to depository institutions other than commercial banks. The impact of whatever level of reserves requirements is set by the Federal Reserve Board should have to take into account legitimate objectives and concerns of the Federal Home Loan Bank Board and other thrift institution regulators. Failure to do so will constrain the ability of the Bank Board to deal with the undue impact of monetary policy on housing.

Thus, while the issue of reserves against transaction accounts is inconsequential in terms of dollar amounts at this time as far as S&Ls are concerned, we wish to go on record that in the event of reserve requirements being imposed on S&Ls against transaction accounts in the future, the Bank Board would hold to the following position:

1. Reserves required against these balances could be held at District Federal Home Loan Banks and not simply on a pass-through basis to Federal Reserve Banks. To the extent that such reserves were held at the District Banks, these Banks should satisfy any interest on reserves requirements.

2. The Bank Board and other oversight agencies impacted by these proposals should have a definite and defined role in the determination and setting of reserve requirements.
We would like to turn to the payment of interest on reserves which would be permitted within constraints under this bill. While we oppose the extension of reserve requirements imposed by the Federal Reserve Board to thrift institutions at this time, we agree that Congress should consider giving the Federal Reserve Board the authority to pay interest on reserves of its member institutions. As we noted above, the payment of interest on reserves represents a preferred means by which the Federal Reserve Board could stem the erosion in membership from the Federal Reserve System. Moreover, we believe that the payment of interest on such reserves has merit on economic grounds.

The fact that explicit interest is not paid on reserves of member commercial banks does not mean that these reserves are totally non-productive. As the members of this Committee know, the Federal Reserve System provides many specific services to its members at no cost, and such free services can be regarded as the equivalent of an implicit payment in return for reserves held at the Federal Reserve Banks. The fact that the Federal Reserve System has a problem of membership attrition despite this indicates that the implicit return in the form of services provided freely are not deemed to be an adequate rate of return on these reserves.

Once we are aware that there is an implicit return already being paid on reserves held by member banks at the Federal Reserve, we are no longer dealing with the issue of whether interest should be paid. The relevant questions become: (1) What should be the rate of interest? and, (2) Would explicit interest payments make better sense than implicit interest?
The Bank Board's position is that an explicit interest rate makes better sense since it permits member commercial banks to utilize the resulting interest in any way that it desires, rather than being forced to accept the services provided free of cost by the Federal Reserve System. As the Bank Board sees it, the payment of an explicit interest rate on reserves is an important precondition to the pricing of services by the Federal Reserve System and the resulting stimulus to greater competition in the private sector in providing these types of services.

Why is there so much controversy generated by the question of whether explicit interest should be paid on reserves? This appears to arise from the concern of some that the payment of explicit interest on reserves would represent "windfall" profits to commercial banks. This is a difficult argument to evaluate for a number of reasons, and the Bank Board would merely like to lay out the issues without claiming to know the answers.

Those who argue that there is no problem of windfall profits could point out that the reserve requirements imposed by the Federal Reserve Board may be unnecessary or, at least, higher than necessary for purposes of effective monetary policy. If so, this would mean that member commercial banks are probably holding a larger volume of non-interest earning assets than is needed.

In evaluating the windfall profits argument, it is useful to view non-interest earning reserves as a tax on commercial banks by the Federal Government. Such reserves also represent a non-interest form of debt of the Federal Government which substitutes for debt that would otherwise have to be issued to and held by the public at a market interest rate paid by the Federal Government. If we view
reserve requirements as a tax, we get into the familiar question of who ultimately pays this tax. Is it the commercial banks themselves, or is the burden shifted onto others?

The burden could possibly be absorbed through a lower interest rate paid by commercial banks on their savings and time accounts, or a higher interest rate or fees charged on various types of loans or services. It is not clear as to what extent the ultimate burden of nonpayment of interest on reserves is shifted onto the member commercial banks themselves or onto others. Thus, if the Federal Reserve System were permitted to pay explicit interest on reserves, we do not know to what extent this would increase the profits of the commercial banking system.

While the Bank Board can support the payment of interest by the Federal Reserve System to member institutions, we do not believe that we can comment at this time on how such interest should be computed and what should be the maximum interest rate permitted on such reserves. However, the Bank Board believes that the payment of interest on bank reserves strengthens the case for removing the ban on explicit interest on demand deposits, as well as the case for extending interest bearing NOW accounts and demand deposits nationally to all depository institutions.

FEES FOR FEDERAL RESERVE SERVICES

We turn now to the provision of the bill which would require that: (1) Not later than July 1, 1979, the Federal Reserve Board shall have prepared and published for public comment, pricing principles and a proposed schedule of fees for Federal Reserve System services; and, (2) The Federal Reserve Board shall put into effect a schedule
of fees for such services no later than July 1, 1980, and any time after July 1, 1979 if it determined such action to be appropriate.

The Bank Board welcomes the explicit pricing of Federal Reserve services. The Board, however, believes that savings and loan associations and other thrift institutions should obtain direct access to these services under this bill at the published schedule of fees, as is provided for in S2595, the Federal Reserve System Services Act. Thrift institutions should be able to avail themselves of direct access to such Federal Reserve services as check collection, wire transfers, settlements, automated clearinghouses, and securities safekeeping. In addition, at the time that direct access to Federal Reserve services is provided, provisions need to be made for settlements, which may require clearing balances at the Federal Reserve for S&Ls.

Access to Federal Reserve services will give S&Ls and other thrift institutions the option of not having to use a correspondent commercial bank to obtain use of these services. Indeed, S&Ls could themselves provide correspondent services as commercial banks currently do.

Of course, direct access does not mean that Federal Reserve services will necessarily be utilized. An important aspect of explicit pricing is that thrift institutions, as well as banks, will be in a position to choose between the Federal Reserve payments mechanisms and those that operate outside of the Federal Reserve System. Private payments mechanisms should be stimulated as a result of explicit pricing by the Federal Reserve Board. We could see considerably more competition as groups of commercial banks and thrift institutions find it advantageous to set up alternative payments mechanisms or to utilize mechanisms of other private entities.
At the present time, with Federal Reserve services offered free to members, member banks have a strong incentive to take advantage of these services, thus reducing the ability of others to compete even if they can offer better services. The Bank Board would note that this bill is not explicit on the pricing guidelines that would have to be followed. We would like to see Federal Reserve pricing done on a private sector entity basis, i.e., pricing which recognizes imputed costs of capital and taxation. Such pricing is necessary for private sector competition with Federal Reserve services.

Thank you Mr. Chairman and Members of the Committee. This concludes our testimony. I will be happy to answer any questions.
Chart 1. Average Interest Rate on New Issues of 91-Day Treasury Bills, and Net New Savings Receipts (Seasonally Adjusted) at FSLIC-Insured Savings Associations--1966-1978, by Quarter
Chart 2. Net New Savings Receipts (Seasonally Adjusted) at FSLIC-Insured Savings Associations, and Private Housing Units Started (Seasonally Adjusted Annual Rate)–1966-1978, by Quarter

Net New Savings Receipts (left scale)

Private Housing Starts (right scale)
Chart 3. Effective Interest Rate on Conventional Mortgages on Newly-Built Homes, and Private Housing Units Started (Seasonally Adjusted Annual Rate) --1966-1978, By Quarter
Chart 4. Private Housing Units Started (Seasonally Adjusted Annual Rate), and Change in Real Gross National Product (Annual Rates) -- 1966-1978, by Quarter
The Chairman. Thank you, Dr. Biederman.

Senator Schmitt has to leave and he's asked if he could ask one question. So I would ask Senator Lugar's permission if he could ask that one question.

Senator Lugar. Surely.

Senator Schmitt. I appreciate the Senator's courtesy and am intrigued by this testimony, maybe even more than I was by Chairman Miller's.

Underlying it, I think is a general belief that the dual banking system and a multifaceted financial system are of value to the country, and have been a proven value for some time.

Now, if there were a system designed to preserve this multifaceted character of our financial system that included a requirement for deposit reporting by all financial institutions, the option for maintaining reserves in order to obtain the Fed services, the availability of the discount window for financing, and then the payment of interest on reserves if in fact reserves were maintained, and maybe even along the interest lines suggested, would that kind of a package protect the kinds of interests that you all—I shouldn't say you have interests that you're protecting—but would it tend to mitigate the problems you see in the proposed bill?

Mr. Lemaistre. Senator Schmitt, I think definitely it would. However, I would suggest that in furnishing these services the Fed ought to furnish them on an explicit pricing basis, as your bill suggested, and that the furnishing of services not be conditioned on the maintenance of reserves. It seems to me that the reserve balances at the moment are the basis for giving free services—free in quotes—to various banks who are maintaining those balances. It would be fairer and perhaps more efficient to say what each service will cost and let the bank select which services it wants and either get them from the Fed or a correspondent bank or wherever they may be available.

I think our whole system would be more efficient if that method were pursued.

Senator Schmitt. But you would not perceive any value in allowing those services to be bought, if you agreed to maintain reserves upon which you could get interest?

Mr. Lemaistre. You mean add pricing to what your first question was and furnish them free if the balance was kept?

Senator Schmitt. No. I would say, if you as a thrift institution or otherwise, would maintain reserves, then you can have access to the services but at the fee schedule. But you could also get interest.

Mr. Lemaistre. Get return on your reserves? Certainly that makes it a more equitable bill. I'm convinced that would be less potentially harmful. Frankly, I'm at a loss to say exactly what the impact of this bill would be on the dual banking system. It's because I'm worried about what might happen to it is why I have raised that question.

Senator Schmitt. You think there are too many incentives to go into national banks?

Mr. Lemaistre. I think you might find a sudden influx into the Federal system from the State system, and there are a few States—more than a few—that probably couldn't operate without maintaining something like their present level of membership in the State system. So to the extent that the dual system is beneficial—and I think it has been
beneficial—it has produced innovations in banking which have been helpful. Whether good or bad, it gives us a proving ground for certain experiments, as is the case in New England. Furthermore, it seems to me that it’s definitely worthwhile to preserve it, and the caution I’m raising here is that we ought not to let this bill be a means of lessening its viability. Because of these fears I raise those questions.

I do think what you suggest is probably the way to approach it, although I would say that if universal reserves are being required simply because of the effect on monetary policy, that I haven’t seen that the need for that has yet been demonstrated.

Senator SCHMITT. You think deposit reporting would have at least some of the effect of universal reserves?

Mr. LEMAISTRE. I think so.

Senator SCHMITT. Mr. Connell.

Mr. CONNELL. Senator, I have no fear that the dual banking system would—or dual financial system will suffer because of universal reserves. As I understand this proposal, it’s strictly monetary reserves and doesn’t propose a full thrust of membership regulation that now exists under the membership system that’s currently used. Therefore, a bank or a credit union or a savings and loan association can choose its charter depending probably upon the operating powers that it has in a particular jurisdiction.

Senator SCHMITT. There’s always the old domino theory, though.

Mr. CONNELL. We have had the domino going the other way, Senator, for the last several years, and I think it’s begun to have its impact on the effectiveness of monetary policy, and that does concern me that we have a number of evolutionary conditions going on right now ranging from freeing up of the controls of interest rates, for instance, that’s one of the Federal Reserve tools for the monetary policies, one of the lesser tools but nonetheless we are beginning to have a movement toward more market determination of interest rates. We have changing or blurring of definitions of money itself which, of course, involves the intermediaries that I regulate, and all these require, I think, a new look at our structure of carrying out monetary policy. And so I’m in favor of the Federal Reserve’s policy, with some modifications that we have in our testimony.

Mr. BIEDERMAN. Senator, I think we would consider all of those areas that you mentioned as improvements on the current bill. But I think one area you may have touched on that needs attention has to do with the role of the Federal Home Loan Bank System and the Credit Union Administration in terms of setting reserve requirements and the question of were these reserves could be held. They would have to be passed through the Federal home loan banks or held at the Federal Reserve banks. I think, in addition to what you mentioned, we feel these issues should be addressed more clearly.

Senator SCHMITT. Well, thank you very much. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you.

I want to follow up what the distinguished Senator from New Mexico talked about. What concerns me—it’s easy to solve these problems just by paying out more public money, pay interest on required reserves. We have never done it in the past. We start with an estimate of $300 million and we could end up with many billions of dollars
before we're through a year. Of course, the people who get it are going to be pushing for it and we know what happens when that develops. We also reduce the earnings of the Federal Reserve and therefore the earnings of the Treasury and the burden on the taxpayer by reducing the reserve requirements. So I think we have to be cautious and careful about that.

We are obviously going to get a push in that direction from the people who are going to benefit from it, but we represent the broad public interest and we ought to be sensitive and aware of the cost of this.

Let me start with Mr LeMaistre. The main issue that we are confronted with is not membership, but rather, whether the central bank should have all depository institutions under its direct or indirect jurisdiction for these purposes: (1) Monetary policy purposes; (2) to assure safety and soundness of the financial system; and (3) to provide for an efficient payment system.

Do you think that universal reserve requirements would accomplish these objectives?

Mr. LeMaistre. I would have to say I'm not convinced that it would.

The CHAIRMAN. You're almost alone in taking that position.

Mr. LeMaistre. I think monetary control depends upon having immediately available the data relative to monetary aggregates, where shifts of funds are going, that sort of thing, and I think the data are available and there is no need for universal reserve requirements.

The CHAIRMAN. Well, how about the issue of equity and fairness that Mr. Miller stressed so emphatically and so hard and I thought so well? I didn't hear any answer to that in your testimony or in the questioning by those of us here in the committee. Why shouldn't all institutions of the same size have the same reserve requirement mandated for them? Why should you have one that can opt out from under reserve requirements by giving up their membership and becoming a nonmember and get that advantage?

Mr. LeMaistre. Well, I would have to say I agree that the present system is inequitable. It does favor the nonmembers.

The CHAIRMAN. Why shouldn't universal reserve requirements be mandated at a moderate level?

Mr. LeMaistre. At a low enough level, I don't think it would hurt. I think the present—well, I shouldn't say this bill because—but the level in the Reuss bill—I think would increase the requirements in about 10 percent of member banks with more than $100 million in reservable liabilities.

The CHAIRMAN. You wouldn't object to that? You wouldn't object to universal reserve requirements if they were exempt for the first $100 million plus 6½ percent above that?

Mr. LeMaistre. I would say that the level ought to be below 6½ percent.

The CHAIRMAN. It's a big loss to the Treasury if you do it that way.

Mr. LeMaistre. If you want to tax the banks, I think you ought to tax them directly.

The CHAIRMAN. The banks have enormous privileges. The banks aren't starving. I don't see many bankers who are on welfare.

Mr. LeMaistre. I'm not objecting to taxing the banks, but I do think it is wrong to tax 40 percent of the banks as we are doing now.
Forty percent of them are leaving money up there on which they earn nothing so the Federal Reserve can earn something.

The CHAIRMAN. We have been doing that for 200 years. We have been mandating requiring reserves one way or another.

Mr. LeMaistre. Right, and we have been inequitable to members for some time.

The CHAIRMAN. Well, Mr. Connell, let me ask you how you feel, whether the central bank should have all depository institutions under its direct or indirect jurisdiction for monetary policy purposes to assure safety and soundness and provide for an efficient system, and whether or not the universal reserve requirements would accomplish those objectives.

Mr. Connell. Mr. Chairman, as I mentioned in my remarks to Senator Schmitt, for monetary policy purposes, very much so. The reserve banking system is dealing with the high-powered money section in terms of money creation and in that area which the Federal Reserve will probably have its most effective implementation.

In terms of safety and soundness, I guess the most graphic example I could think of was in reviewing the Federal Reserve’s recently changed policies on seasonal lending in the last few years anyway. The Federal Reserve relaxed its policy and set up a separate structure for seasonal lending in the agricultural areas. Well, if you don’t have lending in this kind of facility for banks say in the agricultural area or any area that has high seasonal swings, then the financial institution keeps a greater portion of its assets in a liquid, sterile form awaiting the bad time of the year, and that means that for the 2 months that liquidity demands are high, the rest of the year the people in the community suffer from lack of financial resources in terms of credit.

For the individual bank to insure the safety and soundness it will maintain a higher portion of its assets in liquidity and less in loans. So from a safety and soundness standpoint, if the discount window were available, then the safety and soundness criteria would be met without a cost to the local community.

In terms of the payments mechanism again, as we had fewer members, then we have correspondent banking services offered by fewer banks which lowers the number of alternative sources for payments processing and that, too, is not in the public interest.

So, for all those three reasons, I favor the universal reserve concept.

The CHAIRMAN. Very good. Dr. Biederman.

Mr. Biederman. A couple of points. I’m a little confused on the monetary policy question. Chairman Miller surprised me a little bit this morning. They have argued in their testimony several times that this is an important monetary policy tool, but yet there’s an agreement to cut the reserve requirements down. We’ve got to think a little bit just what side they come out on as far as the monetary policy tool.

Basically, we agree with the provisions of the bill. I think to the extent it would promote an effective monetary policy tool clearly is good for the financial system. Our reservations are pretty much oriented toward the question of control and the role of the Federal Home Loan Bank System.

On the equity point, as somebody who has done a lot of work in the tax area, equity is a strange word. You’re always for equity. I would submit, however, that when we start talking about whether this
Bill will increase fairness, we need to look at such questions as increased power, relative powers, and even taxation questions as well. So I would be a little cautious on the equity argument. It has a real nice ring, from the standpoint that everybody should pay the same, but we need to look at a broader perspective as to just what is equitable and what is not.

The CHAIRMAN. If they are the same size institution and they are competing in the same kind of area, it seems to me they should be treated alike.

Mr. BIEDERMAN. If they are competing in the same area, that's right.

The CHAIRMAN. Or with respect to what they are competing in.

Let me ask another question. As Chairman Miller indicated, the Federal Reserve has suggested to Chairman Reuss that $25 million in demand and savings deposits and $25 million in time deposits be exempted from universal reserve requirements.

Now Chairman Miller said that only five thrift institutions would then be affected. I would assume that those five would not be greatly affected because their transactions balances are probably low.

I'd like to get your reaction to that proposal.

Mr. BIEDERMAN. Our figures indicate under the $5 million exemption there would be one S&L affected. Whether that one falls out under the $25 million, I'm not sure.

The CHAIRMAN. He said five thrift institutions. He may be including others than S&Ls. He might be including mutual savings banks.

Mr. BIEDERMAN. From our standpoint, we have to agree with that.

The CHAIRMAN. Well, I would like to get your reaction under those circumstances whether that Reuss proposal, we could put that into effect now or if you wanted to wait. Why wait if the effect is so limited and moderate?

Mr. BIEDERMAN. Well, I guess it's a question of which comes first here. You're right in your observation that we are talking about a pretty small potato from the standpoint of the savings and loan associations.

The CHAIRMAN. At the same time, things are changing.

Mr. BIEDERMAN. If indeed things are changing and we do see increased powers such as NOW account authority nationwide and checking accounts, perhaps they should be considered in tandem.

The CHAIRMAN. Why not put into effect now and as they change then you catch the competition and put it on an equitable basis so everybody is treated alike?

Mr. BIEDERMAN. Well, that's a good suggestion. As I say, as long as things are progressing, we would certainly go along with that. Ultimately we would like to see the question of control in the Federal Home Loan Bank addressed also.

The CHAIRMAN. Senator Lugar.

Senator Lugar. Mr. Chairman, I was intrigued by Mr. LeMaistre's testimony starting where he says, as a matter of principle, whether to pay interest on reserves should not be an issue. Presently, failure to pay interest is tantamount to the imposition of a tax without calling it that. This, of course, gets to some of the dialog that has transpired as to whether if you were going to be equitable you would not simply impose a tax on banks per se or financial institutions, go about it in a straightforward manner as opposed to attempting to level out the circumstances that institutions find themselves in.
But then, you point out, why not permit member banks to invest their reserves in interest bearing securities. In fact, the percentage of assets held in cash would probably be reduced by only a few percentage points. The Federal Reserve could determine what kind of securities would be eligible for this purpose based on considerations such as risk. It might even supply them from its own portfolio. This approach would permit each bank to make its own choice and obviate the necessity of having the Federal Reserve establish a rate. Presently 36 States allow State nonmember banks to hold securities as part of their required reserves in the form of U.S. Government securities.

Now it seems to me this really gets to the heart of the matter. If in fact we are attempting to provide through this legislation safety and security, which the idea of reserves implies, and a certain degree of equity with regard to member banks that have been holding reserves and, others that are about the same size that haven’t been holding reserves and, even more importantly, we should rely upon the good judgment and the management of the financial institutions to determine how they want to go about providing their reserves, provided they do so within the parameters of safety as the Federal Reserve has suggested.

In other words, let the market system work to the maximum amount without imposing a tax which is going to be nonequitable on the face of it, as you let some come in and some come out and have some exemptions and what have you. Obviously, you have testified that you think this is a pretty good idea or at least raised some questions as to why we haven’t considered it, but it clearly gets around the problem of universal reserves in lieu of tax. There is a universal principle here, that any financial institution would be providing some degree of reserves for purposes of safety. If a financial institution could continue to do so and invest in Government bonds or some other security that met the Federal Reserve Board’s strictures, then it would earn income. They are not dead reserves sitting around in various places.

Now this seems to me to be such a good idea. Let me ask you, as an experienced man in Government, what is wrong with it? Why would anybody oppose that idea?

Mr. LeMaistre. Senator, I think I should point out there is a body of thought that a reserve as such cannot be held in any kind of earning instrument, that the only true reserve is something that is equivalent to cash. I must say most of the people who say they are Federal Reserve economists, but the truth of the matter is I think it is a good idea. I think it deserves consideration. The bank which chooses to use this method obviously would not put all of its reserves in interest bearing securities. As Mr. Connell mentioned a moment ago, there are certain seasonal demands which require banks to have a great deal of liquidity either in cash or short-term securities which obviously earn less than the longer ones. So in that case they would tailor their portfolio in the reserve account to their own regional needs.

So it seems to me that it’s worth exploring and that’s why I brought it up, because Congressman Stanton in his proposal asked the Fed to make a study and report on it and it seems to me this kind of study would be very useful to us. At first blush it looks good to me.

Senator Lugar. Mr. LeMaistre, are there any Federal Reserve economists or others who believe that a reserve must be something other
than interest bearing, that problem or that idea is somewhat undercut by the discussion we are having. In other words, it seems to me that clearly Chairman Miller and others are suggesting that in fact interest be paid on reserves. So that I appreciate the fact that that may be one objection that would have been lain against your idea before, but clearly it's not one now. That's the nature of the argument we are having, how much the rate ought to be and where the incidence of this ought to fall.

Chairman Proxmire has pointed out if the incidence falls in such a way that the Treasury simply loses $200, $300, $400, or $700 million a year transferred to bankers, then there are some objections to that idea. Clearly the idea you have is one in which apparently bankers are not obtaining any additional revenue from the Treasury via the Federal Reserve Board. They are taking the chance in the market of whatever rates of interest are available. As I say, I wanted to highlight this because it just seems to me to be commonsense. I'm opposed to an idea of a tax under the guise of something else. I'm opposed to almost all ideas that move away from the market when we really do not need to do so at all. In other words, it became simply a bureaucratic strategy to gain greater control, but before leaping at your testimony, I just simply wanted you to explain while you're here as a witness what the pros and cons were of the thing.

Mr. LeMaistre. As I say, I think it deserves study. I'm not saying it's the sole answer and I think it should be pointed out that in those States where reserves are held in interest bearing securities the entire reserve is very seldom held in that sort of way. As I understand it, they are usually rather small. Most of it is cash or correspondent balances or something of that sort. But even so, that is the banker's decision and I think he should be permitted to make that business decision for the best interest of his own institution.

Senator Lugar. Mr. Connell or Mr. Biederman, would you have a comment on this discussion?

Mr. Connell. In comparing State reserve statutes to the Federal Reserve System, I think there is a distinction between a regulatory reserve set up under State law where the purpose of the reserve is to provide liquidity for periods of stress and so on as a safety matter; and a monetary reserve which is designed to remove money from the banking system and there is, as Chairman LeMaistre indicated, a body of thought that if the reserves were kept in securities of some sort that the ability of the central bank to exercise its monetary policy function in a rational reserve concept is not achieved, and that's the principle that's being questioned on this. Payment of interest on reserves, because if the reserves can be reinvested and they do not result in the monetary policy objective of limiting Federal control, then it just doesn't work. So that's essentially the way I see it. I thought about this business of keeping reserves in securities, particularly with respect to credit unions and that question arose, so I had to back off quite frankly.

Senator Lugar. Let me just pursue it for a moment. Let's say for purposes of monetary control as opposed to safety, I think that's an important distinction, that the Federal Reserve Board decided the type that was required and therefore said through its guidelines what you can do with your money as a banker—you must invest a percentage more in Treasury bonds. Now isn't this a degree of monetary control in
which clearly you can’t invest in something else, and yet at the same
time you have to establish a rate and deprive the taxpayers money
circling back to the Treasury and so forth?

Mr. Connell. That’s how it appeared to me at first and then the
question arose whether in that process as the financial institutions pur-
chase treasuries or whatever, whether they don’t release moneys to be
reloaned or reinvested elsewhere, and I guess the question really being
that when the Federal Reserve withdraws the money into the Federal
Reserve System it’s sterilized for monetary policy purposes and rein-
vestment but not so for—maybe not so if those reserves were kept in
some money market instrument, treasuries, or whatever. I guess the
question arose whether that could effectively sterilize reserves for
monetary purposes and that there is a body of thought that it doesn’t
sterilize the money.

Senator Lugar. Mr. Biederman, do you have any comment?

Mr. Connell. I don’t understand it quite frankly indepth, but the
question arose so we would recognize it.

Mr. Biederman. The problem here is, using Federal Reserve num-
bbers, that you’ve got a situation where the banks are apparently being
taxed, if you will, some $650 million more money than they feel would
be fair, given the return they would be getting on their services. The
horn of the dilemma is do you address this by lowering the reserve re-
quirements to make up this difference because you’ve got the reserve
requirements down, and then reduce the monetary policy tools as a
consequence, or do you explicitly, as you would price the service, pay
interest, and take a market solution. I think I would tend to lean
toward the direction of the market solution to the extent you don’t
get into a price-fixing situation.

On the other hand, and I can understand the chairman’s viewpoints
on this particular point, you get into the question of “are you providing
some sort of windfall profit to the banks, would some banks be over-
compensated, and so on?” There are two basic sides to this argument
and it becomes a matter of approach. Clearly you’ve got banks that
are saying these services aren’t worth it and we’re getting out of the
system that needs to be addressed in some way.

Senator Lugar. Thank you.

The Chairman. I think Senator Lugar has characterized a very in-
telligent question and one that bothers many people, but I think Mr.
Connell gave a reasonably good answer. If you do permit everybody—
and I think to be fair you would have to permit the Chase Manhattan
and National City and Bank of America to do the same thing—if you
permit everybody to put their reserves in earning assets, the Treasury
obligations, and there were no sterile reserves, then if the Federal
Reserve wanted to act to reduce or increase in the money supply it
would be impotent. They wouldn’t be able to do it because just exactly
as you say, if these funds went into Treasury bills, for example,
Treasury bill interest rates would tend to fall. Then that would mean
that more money would be available elsewhere and you wouldn’t have
an effective monetary policy. The notion that you shouldn’t tax banks
unfairly is a very good point. On the other hand, there is a windfall
here—you know, banks alone are in a very, very advantageous position
with respect to Federal taxes. They pay something like 16 percent of
their net profit in taxes compared to over 32 or 33 percent for other
corporations on the average.
So they do have that big advantage. They also are given a monetary power to create money that is unique and unusual. Furthermore, the proposal by both Chairman Reuss and Chairman Miller would moderate the effect on banks by greatly reducing the reserve requirements that they have to pay whether it’s 6½ percent or 7 or 9 percent; it would be less than it is now for the big banks, and zero for banks with either $100 million or $50 million in deposits. So you would have a great benefit to the banks to begin with. You would also, because you would universalize reserve requirements, make it possible for monetary policy to work effectively with a lower level of reserves.

It seems to me that’s a reasonably equitable approach. I don’t mean to put you in an embarrassing position, Mr. LeMaistre, but you seem to be the lone holdout today. I don’t mean the lone holdout. Obviously you have many, many supporters, but the witnesses this morning seem to disagree with you.

Mr. LeMaistre. Mr. Chairman, I’m not holding out in the sense that I say there’s no other way to do it, but I do think the matter deserves considerable study. It is worth taking the time to see whether there’s any objection to universal requirements.

The Chairman. I don’t want to be unfair to you, but let me put it bluntly because sometimes when we get a little blunt we get a better give and take here. You say universal reserve requirements might cause a massive influx into State member and national systems and you say the supervisory authority of the Federal Reserve and the Comptroller of the Currency would grow substantially without the benefit of congressional consideration. Of course, this would also mean that the supervisory authority of the FDIC would diminish. Isn’t that the real reason why the FDIC is against universal reserve requirements? It doesn’t want to lose a part of its turf?

Mr. LeMaistre. I’m not aware that that’s the reason. It’s not my reason. I’d have to say I’m not even sure that the FDIC needs to stay in supervision. Our primary purpose, of course, is somewhat like the Fed’s, to make sure of a constant safe money supply, and my only reason for raising that point is that I don’t think the dual banking system can survive if half the States drop out of bank supervision. It just seems to me we have to make sure that that doesn’t happen and whether we’re the ones that are examining those State chartered institutions or the Fed or the Comptroller doesn’t really make a lot of difference to me, but I don’t think you can operate without the State system if you want to keep the benefits of the dual system.

The Chairman. Mr. Biederman, how many savings and loan associations would be affected by the universal reserve requirement imposed by the bill this committee is now considering?

Mr. Biederman. I think as I mentioned earlier, one.

The Chairman. Now on that basis, how can you maintain that universal reserve requirements should not be applied to savings and loan associations at this time?

Mr. Biederman. I guess I get back to my earlier point. We are not opposed to the concept as long as we also address simultaneously the question of the increased powers from the standpoint of NOW accounts and checking accounts.

The Chairman. I want to be sure I understand. Did you say if nationwide NOW accounts or something similar become authorized
for savings and loan associations you would then not oppose the reserve requirements?

Mr. Biederman. That they should be addressed at that time—the Bank Board has been on record in the past that they would support the concept of universal reserve requirements.

The Chairman. All right. Mr. Connell, in your testimony you said that an undesirable effect of the decline of the Federal Reserve membership is the return to the practice of pyramiding reserves of banks of increasing size in proximity to the money market. Membership itself is not the key to this, is it? Isn’t the holding of reserves with either the Federal Reserve or a correspondent the choice?

Mr. Connell. That’s it and under the present system of course where under State law a bank can hold its reserves with a correspondent and it receives from the correspondent the implicit service payment, they will then keep those reserves with the correspondent. As fewer banks are members of the Federal Reserve System, there’s greater depositing in the money center banks as the correspondent left to do business. For instance, in Connecticut, we had three or four medium-sized banks in the $300 million-plus category that had been active in correspondent banking withdraw from the system and that would leave only a handful of banks in the correspondent system. So this trend, if it continues, and if the earnings pressure continues, we’d have more and more money moving in that fashion in correspondent balances to the money center banks and that is pretty much what happened in the late 1800s in terms of the correspondent banking and the problems with the pyramiding phenomena.

The Chairman. Are you arguing that the reserves be kept with the central bank?

Mr. Connell. Yes.

The Chairman. Mr. LeMaistre, you indicated in your statement that economists reject the need for equal reserve requirements for members and nonmembers and particularly you cite the work by Dennis Starleaf. Dr. Starleaf commented on the NOW account bill and he mentioned the results you cite but he said, “One is tempted to conclude from my study results that reserve requirements are not needed for money stock and control. However, at this time I’m unwilling to draw such a conclusion.” He indicates a lack of nonmember data and lag of reserve requirements influenced his results and the proposition would be consistent that the reserve requirements enhance monetary control without these factors.

Do the other studies you rely on take these factors into account and were they done by monetary policy experts such as Dr. Starleaf?

Mr. LeMaistre. I think so. I think that Prof. Robertson, Prof. Phillips and Carter Golembe speak to those issues.

The Chairman. If the Federal Reserve indicated that it needed data on deposits at credit unions, Mr. Connell, both Federal and State, on say a weekly basis, could you provide it?

Mr. Connell. Yes, we would. We could set up a weekly system. I think we could set it up, particularly given the small number of credit unions involved in the proposal.

The Chairman. Mr. Biederman, the question of what constitutes a transaction account hasn’t been resolved. Certainly, some savings accounts at both banks and thrifts can be used for transaction pur-
poses either directly or by telephone transfers and automatic transfers will add to the usefulness of savings account purposes.

In your view, how should savings accounts be treated, as transaction accounts or time deposits?

Mr. Biederman. I think they should be treated like time deposits.

The Chairman. Without qualification? Would you explain why?

Mr. Biederman. Well, when you say treated, you mean under this current bill?

The Chairman. That's right.

Mr. Biederman. Savings deposits for thrift institutions should not, I don’t believe, be included under any reserve requirements at this time. Maybe perhaps I misunderstood your question, but I do believe that automatic transfer provision—that there should be some sort of reserve requirements for that.

The Chairman. How do you do that if it’s not through an account?

Mr. Biederman. How do you do what?

The Chairman. How do you treat the savings accounts?

Mr. Biederman. Currently?

The Chairman. Yes.

Mr. Biederman. We have a liquidity requirement against savings accounts on short-term borrowing in the Federal Home Loan Bank System. It varies from 4 to 10 percent. It’s a requirement that 4 to 10 percent of savings plus short-term borrowings be held in certain short-term assets.

The Chairman. Let me ask Mr. Roberts, the committee’s chief economist, to follow up on that. He has trouble with your answer.

Mr. Roberts. I’m concerned about the treatment of the savings deposits that enter into the automatic transfer arrangement with demand deposits. How do you differentiate that type of savings deposit for transactional purposes, from other types of savings deposits?

Mr. Biederman. Well, I think at this point it has to go through the authority in order to make the transfer. It has to deal with the authority that the transfer can in fact take place. In the case of savings and loan associations no such authority exists.

The Chairman. Now, Mr. Connell, you mentioned that the committee should consider changes in the selection and tenure of Reserve bank directors and Board members. What changes would you recommend? Shouldn’t the Federal Reserve bank presidents be made more accountable?

Mr. Connell. Mr. Chairman, I go back about a year ago when I was testifying on S. 2298, when I suggested that the membership of both the Federal Reserve bank directorships be broadened to include a greater cross-section of the community, including representatives of State government, and I think I will continue with that. Of course, with increased authority comes increased accountability and so I would think that the Congress should consider again the retention and membership of the Board of Governors as well. I don’t have any specific suggestions at this time but my main concern I think is with the local banks, particularly, that a broader cross-section of the community be included. Of course, as the Board impacts other intermediaries, then a system of communication has to be set up so that the impact on other intermediaries and the people that do business with them are considered also.
The Chairman. Senator Lugar.

Senator Lugar. Mr. Chairman, staff has provided with certain information and just for the sake of argument let me cast these figures for you. I think Mr. McLean, the committee staff director, indicates that about $27 billion of sterile reserve accounts are in the Federal Reserve Board jurisdiction now and essentially it's from this money that the Federal Reserve Board makes some revenues that are then turned over to the Treasury.

One of the problems of the dialog that I was having with Mr. LeMaistre—I supposed it would come down to the point if in fact $27 billion of sterile reserves was substantially dissipated, as it might be—if member banks of all sizes, those now in and out and so forth, make their investments on their own, maybe Mr. McLean indicates $4 or $5 billion might be left over for clearing of transactions or other technical reasons, but maybe $20 billion, maybe $22 billion would disappear, which means that the Federal Reserve Board would then not be making money on that money and the Treasury would not receive that income.

Chairman Proxmire mentions a fact which is important in the equation; that is, that the banking system as a whole may not pay in terms of corporate taxes as high a rate as do some other firms. There would be different situations. To the extent that a fairly hefty income tax is paid by banks, the question I suppose could be raised whether this new-found income of banks receiving on their own in Treasury securities would not lead to higher income which would in fact be taxed and money derived to the Treasury in that respect.

I raise all of this not to try to resolve it, but to indicate that I think we are onto an intriguing area in terms of the incidence of taxation and the benefits or the losses to the Treasury and in fact really who ought to be controlling the whole process. As I have admitted, I'm intrigued by the thought that probably rather than having an arbitrary situation by the Federal Reserve Board, banking systems would be healthier if the Federal Reserve Board set the parameters of what was illegible for reserves and let the banks make their own decisions even if it meant the Federal Reserve Board had $22 billion less to play around with in the process this is a very different sort of proposition from which we entered the discussion of this legislation and it leads me to believe that before proceeding very much further with the legislation we ought to begin taking a look at how reserves and safety and monetary policy can in fact occur with the strengthening of free market decisionmaking as opposed to taking for granted that sterile reserves per se are a good thing, unless we take the proposition that Federal securities are inherently unsafe to the point that there is no portfolio parameter that is possible, which of course poses a whole set of different problems.

Trying again on this basis, does anybody have a comment? Mr. Connell, your eyes seemed to light up at the thought.

Mr. Connell. Well, the tough balancing act is really the impact on the Treasury in terms of the loss of revenue versus the indirect tax benefit on the financial institutions that are members or prospective members and that's I guess one policy argument. But the other, in terms of keeping reserves in money market instruments is being ques-
tioned as to its effect on the availability of the Federal Reserve to exercise monetary policy and I think I would want to feel very secure that the Federal Reserve could achieve its monetary policy objectives before I would recommend that the reserves be kept other than in the sterile form.

I guess it really comes down to the issue of equity in terms of the cost of membership and the big problem has been that years ago when interest rates were relatively low, when access to the discount window was an important business tool for the 1930's, times have changed and interest rates are high and the services are not providing the return comparatively speaking that are available in the marketplace and the market system has resulted really in erosion of the Federal Reserve membership to the point where it's reached public policy concern to make the Federal Reserve Board request consideration by the Congress.

Senator Lugar. But indeed the erosion problem as far as public policy, I think we got back to the chairman's thought that we're talking about an efficient payments system, safety and soundness and the ability to effect monetary policy—that these are objectives that we're trying to arrive at. Now Mr. LeMaistre has suggested that monetary policy is much less a consequence of having sterile reserves in large bulk at least as I see it—he suggests other reasons—but obviously honest people can differ on what it takes to effect monetary policy. Maybe you need $27 billion. Maybe you need more than that plus a more universal access to the attention of financial institutions, large and small.

Mr. Connell. I guess, Senator, this is the place where Mr. LeMaistre and I differ. I feel that the tools of the Federal Reserve to implement monetary policy have seriously eroded over the last 10 years, again ranging from interest rate controls to the definition of money, to the developing of the securities market and so on. It's a very complicated situation, but it seems to be moving all against the Federal Reserve's ability to carry out its fundamental purpose.

Senator Lugar. I suppose the question then is raised as to how much more control is to be obtained through what appears to be a fairly narrow packaging of prices for services and the additional universal reserved requirements. Granted, there are all kinds of things going on in the world monetary markets as well as our own, the securities markets and what have you.

Dr. Biederman, do you have any comments?

Mr. Biederman. A couple comments on your taxation observations. I think you hit two points on the head here. There is a school of thought that says, "there would be no real windfall profit, that the burden of this extra cost is really on the savers and on the borrowers, it's been shifted forward, and if there was payment of interest on the reserves, then they would benefit." I'm a little suspicious of that argument.

I think, particularly, on the side of the savers, because of regulation Q ceiling, that one might have to contest whether, in fact, any burden is shifted here. As to whether taxes would go up in the case of commercial banks because earnings would go up, clearly they would. However, I wouldn't bet the family jewels on just how much, given the history of this thing in the past, and the tendency for com-
commercial banks, quite legitimately, to make objections to reducing their tax burdens.

Senator Lugar. Well, you would have maybe a part of the argument that surrounds it presently if you have a certain degree of liberation of opportunity of greater pursuit of enterprise and an expanding pie, but aside from that, of course, there are many reasons why banks don’t pay as high a levy on the Federal level which is because they invest in municipal securities. And so the question then, I suppose, is whether they ought to do that or not or it might be a good question now as to if that is a pretty healthy thing as to the status of local governments.

Do you have any further comment, Mr. LeMaistre?

Mr. LeMaistre. Senator, I would have to point out that banks pay about 16-percent rate on their income tax because the Congress decrees that’s what they shall pay, and if you want to attack it to increase the income of the Treasury, then that seems to me is a proper place to do it.

Senator Lugar. It’s more equitable thing than trying to fool around with the universal requirements and ins and outs and this sort of thing.

Mr. LeMaistre. I think a lot of people have the conception that banks pay a very low rate of income tax and I think that probably some of that is justified, but nobody ever considers what they forego on their reserves, income which might otherwise be taxable.

Senator Lugar. So while we’re involved in what amounts to sort of a truth in packaging and truth in lending or truth in pricing, we could get into a truth in taxing and see what the incidence is of the flow.

The Chairman. I don’t want to hold my breath until the banks start to pay the same share as everybody else on their income.

Mr. LeMaistre. I predict it would pass if you called it truth in something.

Senator Lugar. That may very well be.

The Chairman. Thank you gentlemen very, very much. I think you have been excellent witnesses and made a good record. Tomorrow we are going to hear from the State Bankers Association, the New York Commissioner, American Bankers Association, the Independent Bankers Association, a panel of three bankers representing smaller banks.

The committee will stand recessed until 10 o’clock tomorrow morning.

[Whereupon, at 12:25 p.m., the hearing was recessed, to be reconvened at 10 a.m., Tuesday, August 15, 1978.]
State of New York. We are delighted to see you again and go right ahead.

STATEMENT OF MURIEL SIEBERT, BANKING SUPERINTENDENT, NEW YORK STATE BANKING DEPARTMENT

Ms. Siebert, I am Muriel Siebert, superintendent of banks of the State of New York. I am grateful for the opportunity to appear today before the Senate Committee on Banking, Housing, and Urban Affairs on the subject of S. 3304.

This bill addresses itself to the imposition of reserve requirements on transaction accounts, the payment of interest on reserves held in
Federal reserve banks, and the imposition of charges for certain services offered by the Federal Reserve banks.

Let me speak briefly to each of these points.

The bill would require the maintenance of uniform and universal reserve requirements on all transaction accounts held in all depository institutions where the transaction accounts total more than $5 million. This would encompass demand accounts at nonmember banks, checking or NOW accounts at thrifts, and share drafts at credit unions. The Federal Reserve Board would have discretion in setting the required reserve ratio within statutory boundaries of 7 to 22 percent for demand accounts and 3 to 12 percent for other transactions accounts. Finally with respect to reserve ratios, the statutory range of reserve ratios on time and savings accounts for member banks would be broadened to reduce the minimum from the current 3 percent to one-half of 1 percent.

Reserve requirements perform two important economic functions. The first is to assure a minimum level of liquidity at all deposit-taking institutions. This adds to the stability of individual institutions and of the financial intermediary system. I suspect that this was the motivation for the reserve requirement provisions of the New York banking law which date back decades before the establishment of the Federal Reserve System. It is also, I suspect, a part of the motivation for the presence of requirement provisions in the banking statutes of every State with the sole exception of Illinois.

The liquidity function of reserves is a matter which prudent bankers would see to on their own, and the statutory requirement is therefore intended to protect against the excessively speculative. But the liquidity function of reserves clearly does not require that the reserves be held in the form of liabilities of a Federal Reserve bank. And indeed almost all States permit their nonmember banks to hold reserves in the form of deposits at other banks, and many States allow interest-bearing securities such as U.S. Government obligations as eligible assets for this purpose. I might add that English banks, which are subject to reserve requirements, are permitted to hold at least a portion of their reserves in the form of Government securities and other earning assets.

Once reserves are established, competitive equality problems arise among various classes of financial institutions. Thus, when New York State-chartered thrifts received the new power to offer checking accounts in 1976, the banking department felt it appropriate to propose legislation requiring them to maintain reserves at nonmember bank levels. This legislation, by the way, has not yet been adopted.

Moreover, the liquidity function of reserves can be fulfilled without requiring that reserve ratios be uniform in different areas or for different classes of banking organizations. Indeed, the structure of bank regulations, including the Federal Reserve Act itself, has always recognized different needs for reserves for city banks and country banks and for big banks and small banks.

The flexibility of permitting reserve requirements suitable to the needs of individual financial systems, particularly for smaller and country banks, seems, from this perspective, preferable to a uniform national requirement. The bill before you already recognizes the need for some flexibility by permitting the Fed to set reserve requirements...
within fairly broad statutory ranges. I think that the Congress would want to give some thought to giving explicit guidance to the Fed on the possible desirability of taking regional and size characteristics of banks into account in setting specific reserve requirements.

The second important function of reserve requirements within our current economic structure is to facilitate the conduct of domestic monetary policy by the Federal Reserve System. I want to state at the outset that the conduct of monetary policy is not within the scope of responsibility of the New York State banking department. I am, however, aware that a number of acknowledged experts have questioned whether reserves are a necessary, or even a helpful, component of control over the money supply. Chairman LeMaistre of the FDIC, in his August 4 testimony before the House Committee on Banking, Finance, and Urban Affairs on similar legislative proposals, discussed in some detail the studies of these experts. I am sure that your committee will hear testimony from many economists on this question.

In preparation for my testimony I reviewed the reserve requirement practices of other major Western nations where New York banks operate branches and which have substantial foreign branch operations in New York. My research revealed the interesting facts that Belgium and Switzerland do not have in place any reserve requirements at the moment. I am not aware of any substantial concern that the Belgians and the Swiss are unable to control their domestic money supplies.

I would not, however, conclude from this that reserve requirements are unnecessary within the context of our institutional configuration in the United States. The issue, as I understand it, is that the Fed needs to have knowledge of the relationship between the volume of bank reserves and the supply of money. This relationship is less stable and less well known in an environment where the money creation function is carried out by a large number of different banks, subject to different reserve requirements, held in different forms, and reporting on their activities on different schedules. Posed this way, the issue is one of the Fed's access to accurate and timely information. I note that Congressman Reuss shares this perception of the problem. There may be less drastic and more democratic ways of resolving this issue than forcing all depository institutions to keep reserves essentially as if they were Fed members.

I might add that this question is especially timely as we enter the era of automatic transfers from savings to checking accounts, for this program may cause a larger volume of consumer deposits to be maintained as lower reserve savings as opposed to higher reserve checking balances. This will have the transitional effect of further blurring the Fed's command over monetary statistics, and the long-term effect of raising the money multiplier. So the issue of improving the Fed's control over monetary data is a worthwhile topic for discussion.

The second major item in the bill is the authorization of the Fed to pay interest on reserve balances maintained at Federal Reserve banks. I support this proposal both because it is reasonable on its face for banking organizations to have some return on these funds and because it will reduce the current disparity between member and non-member banks.
I note that there is some debate over what level of interest payments the Fed should be required or permitted to make on reserve funds. The closer we get to uniform reserve requirements with reserves to be held in the form of deposits at a Federal Reserve Bank the more the level of interest payments becomes an issue to be settled by debate rather than by competition in the marketplace. To the extent that reserves are held as correspondent bank balances, I think the competitive factors of the marketplace will give good guidance on a realistic rate of interest the Fed could pay.

As a bank regulator responsible for thrifts as well as for commercial banks, I do want to emphasize that if a market rate of return on mandatory reserves is not forthcoming, that this will have a substantially more severe negative impact upon the thrifts than upon commercial banks.

I might add at this point that some thought should be given to permitting explicit interest payment on interbank demand balances. The historic compensating balance method of paying for correspondent services could, I think, be improved by an unbundling approach similar to that contemplated for the Federal Reserve banks by this bill. I think further study of this question is warranted, especially in view of the concerns raised by recent events about the correspondent banking system.

The last part of S. 3304 would require the Federal Reserve, by July 1, 1979, to distribute for comment a set of pricing principles and a proposed schedule of fees for services offered by Federal Reserve banks, and, by July 1, 1980, to put into effect a schedule of fees for such services which is based upon those principles.

I strongly endorse the concept of unbundling and charging appropriate prices for the services the Federal Reserve banks provide to commercial banking institutions. On the other hand, I recognize that this concept raises many and difficult questions. I therefore note with approval that the American Bankers Association has decided to undertake a major study of the potential impact upon the banking industry of the Fed proposal, particularly this part on the unbundling of prices.

The pricing proposal will impact differently upon different categories of banking organizations. Correspondent bankers would probably support a system of pricing Fed services which would enable them to compete more effectively with the Fed for provision of these services. There is certainly much to be said in support of having the Fed set fairly and state explicitly the prices charged for various services. This would strengthen competition and be beneficial to buyers and sellers of correspondent services, and it seems equitable where a governmental entity is offering services in competition with the private sector.

At the same time, I must say that I share the concerns expressed by Federal Reserve Governor Philip E. Coldwell, for the smaller, rural banks’ problems which might result from this pricing proposal. At present, the Fed subsidizes these banks by charging them less than cost for provision of services. This pricing proposal might result in the Fed ending this subsidy and charging the small, rural banks at actual cost for these services. I, too, am eager to see the plans of the correspondent banks for providing services for the smaller, rural
banks. I think a hardheaded review of the American experience with the postal monopoly will provide a valuable cautionary tale as we enter the uncharted waters of explicit Fed pricing in competition with private clearing houses and correspondent banking institutions.

We will need the time provided for in this bill to sort out these questions before a pricing system can be put in place.

I hope that these comments will assist you in your deliberations on the reserve requirement and other Fed membership issues. I thank you again for affording me this opportunity to share these comments with you.

The Chairman. Thank you very much, Superintendent Siebert. You have made a lot of very valuable and interesting points about reserve requirements and the issue of universal reserve requirements proposed by the Federal Reserve, but you haven’t indicated whether you favor universal requirements as an equitable way to solve once and for all the problems facing the Federal Reserve. That is, as we know, an erosion of their reserve base. That reserve base has implications for monetary policy control, for safety and soundness of the banking system, and for the efficient functioning of the payments mechanism.

So where do you stand on that issue? Do you favor universal reserve requirements or do you oppose them and why?

Ms. Siebert. I believe that the States can set reserve requirements. We require reserves which are held as deposits. I don’t think that they have to be held at the Fed in a non-interest-bearing form. I believe that we should permit interest-bearing certificates like Treasury bills.

The Chairman. Well, the argument that Chairman Miller made yesterday is this ought to be on an equitable basis. We ought to treat everybody alike. If the States have one reserve requirement system, either their reserve requirements are less or their reserve requirements permit banks to put their reserves in earning assets, it’s unfair competition with the banks that are members of the Fed and have their reserves sterilized and get no return at all on them or have a higher reserve required.

Why shouldn’t institutions of equal size, engaged in the same business be treated equally?

Ms. Siebert. Well, I think most of our larger banks are members of the Fed. It’s the smaller ones that are pulling out of the system.

The Chairman. As you know, the problem of the smaller banks would be handled by both the Fed proposal and the chairman of the House Banking Committee’s proposal, by simply exempting the deposits—I think the Reuss proposal is to exempt the first $100 million. The Fed would, as I understand, demand deposits would have a similar exemption but would exempt $50 million.

Ms. Siebert. I think if you exempt the first $50 million you’re not going to hurt the smaller banks. I believe in New York State we have 10 nonmember banks above that level. The largest is the Bank of Tokyo Trust which is a wholly owned New York State chartered bank. It is owned by the Bank of Tokyo, and I believe it is the largest bank in the country that is not subjected—the largest State-Chartered bank—that is not subjected to Fed reserve requirements.

The Chairman. Why wouldn’t that meet your objection as far as the smaller banks are concerned and also the desirability of treating competitors alike by having, as the Federal Reserve Board proposed,
a uniform level of reserves across the board with a uniform exemption for the first $50 million or so on deposits?

Ms. Siebert. Well, $50 million, I could probably take. Although I would like to review the incentive which would be created for State-chartered banks with under $50 million in reservable liabilities to convert to national charter since they would thereby avoid all reserve requirements. I'd have to study the figures of the number of banks in our State. I think we have only 10 commercial banks over $50 million in deposits that are not members of the Fed. In our thrift institutions it's a different situation and the thrifts would be penalized because they are paying interest on deposits. They have no way to get public capital in the State of New York. Our thrift institutions are mutuals. They cannot go out and sell additional equity to the public. The credit unions increase their capital by retained earnings. So if we put a reserve requirement on the entire accounts for those credit unions that offer share drafts around the country you will be penalizing the earnings to institutions that cannot legally go out and sell additional shares. They have no way to increase their capital base. In New York State, all of our savings banks—and we have about $80 billion of them—are all mutually owned and they cannot sell additional capital stock.

The Chairman. As you know, the Fed proposal would only cover the transaction accounts of the thrifts. It wouldn't be universal coverage. But I don't see any reason why they shouldn't be treated alike with respect to their transaction accounts. That's in competition with the commercial banks.

Ms. Siebert. With the checking accounts, yes.

The Chairman. That's what they would propose. I would agree with you that they shouldn't cover the other accounts, the time and savings accounts.

Ms. Siebert. When they go into the credit unions which offer share drafts, I believe they are suggesting that the entire account be included because the share draft is against the entire account.

The Chairman. The share draft would have the same exemption I understand. They wouldn't include it.

In your testimony you say Belgium and Switzerland do not have in place any reserve requirements at the moment. I note that in both countries the central bank has the ability, if they wish to do so, to apply mandatory reserve requirements on all banks.

Do you know of any central bank in any country anywhere that doesn't have the ability to apply mandatory universal reserve requirements except the Federal Reserve in the United States?

Ms. Siebert. I do not know of any. Wait until I ask my counsel, please. He doesn't know of any either.

The Chairman. So that the experience of other central banks is that they all have at least the authority to do so and the power to do so.

Last year this committee held hearings on both correspondent banking and the role of the Federal Reserve in the payments mechanism. At that time I said I favor allowing payment of interest on interbank correspondent balances and unbundling of services. Do you think this should be permitted separately from a resolution of the issue of interest payment on all demand deposits?
Ms. Siebert. Yes; I think that the services should be unbundled. I had occasion to study some of the reports of our major money market banks, some of the internal reports we get through our examination process, and I think the pricing should be separate so that they can charge and be paid accurately and that the correspondent banks, the smaller banks that use correspondents, have the ability to go out and shop.

The Chairman. I think so, too. I think this would add an element of competition and efficiency. It has served our country very well and I think we ought to apply it here. Interest payments on demand deposits are now, as you know, prohibited by law and have been for some years, yet many banks allow both their correspondent bank and corporate customers an earnings credit on their demand balances. Are you familiar with these practices and do you think they are a violation of the prohibition against interest payments on demand deposits?

Ms. Siebert. We haven't seen any in our examination reports. I think it would have been called to my attention pretty fast.

The Chairman. Earning credit on demand balances, you aren't familiar with that?

Ms. Siebert. I can look into it, but I have not seen it.

The Chairman. We'd appreciate it if you could look into it because we understand that has been in practice. Of course, New York being such a big State and so particularly important in banking, if you haven't seen any there it's very significant I think.

Well, I want to thank you very much, Ms. Siebert, for your excellent testimony. We appreciate it.

Ms. Siebert. Thank you.

The Chairman. I'd like to ask a panel of John H. Perkins, president, Continental Illinois National Bank and Trust Company, Chicago, Ill., and president-elect of the American Bankers Association; and Thomas F. Bolger, president, McHenry State Bank, McHenry, Ill., and second vice president, Independent Bankers Association of America to come forward. This is kind of an “Illinois day. Up in Milwaukee we have a State fair for Wisconsin and we have an “Illinois” day at the State fair. So this is “Illinois” day at the Senate Banking Committee.

We are delighted to have you. We have three other witnesses following you, so we would appreciate it if you could confine your remarks, if possible, to 10 minutes or as close to that as you can. For your guidance we are going to flick on the light over there. It will be green for 9 minutes, then yellow for 1 minute, and red means that’s it.

STATEMENT OF JOHN H. PERKINS, PRESIDENT, CONTINENTAL ILLINOIS NATIONAL BANK AND TRUST COMPANY, CHICAGO, ILL., AND PRESIDENT-ELECT, AMERICAN BANKERS ASSOCIATION, ACCOMPANIED BY CHARLES F. HAYWOOD, PROFESSOR OF ECONOMICS, UNIVERSITY OF KENTUCKY

[Complete statement follows:]
Chairman Proxmire, and members of the Committee, I am John H. Perkins, President of the Continental Illinois National Bank and Trust Company of Chicago, and President-Elect of the American Bankers Association, a trade association whose membership includes more than 92 per cent of the nation's 14,383 full-service banks. Accompanying me is Charles F. Haywood, Professor of Economics at the University of Kentucky and consultant to our Association.

We are delighted to be here today to testify on the important proposals before your committee. There are few absolute certainties in any of the arguments pro and con to the proposals for change. All of us are having to speculate about living in a Federal Reserve operating environment none have experienced. The first question for consideration should not be: How do we maintain a relatively high level of membership in the Federal Reserve System? Rather, more fundamental objectives should be clearly stated. Our Association believes these objectives are paramount:

--To assure the continued independence and effectiveness of our central bank in its management of monetary policy,
--To enhance the efficiency of the payments system, and
--To eliminate arbitrary forms of discrimination against particular types of financial institutions which inhibit the delivery of banking services at least possible cost.

S.3304 is a constructive attempt to deal with the first two concerns, although we do have some disagreements with specific aspects of this proposal. Our third concern is barely addressed in the proposal. There appears, in fact, to be an attempt to justify discrimination against medium-sized and larger banks on the grounds that they are not leaving the Federal Reserve as frequently as smaller banks and, hence, do not deserve the same level of relief from the excessive burdens of membership. Even if this is accepted as valid at the moment, it will not be valid in the future as more and more banks examine the value of membership. There also appears to be a belief that such discrimination
will mitigate Treasury revenue losses. The first notion is simply unfair, and, as we shall discuss below, the second is probably incorrect.

In discussing legislative and regulatory proposals, the policymaking bodies of the American Bankers Association attempt to discipline their thinking by asking four questions:

--How do bank customers benefit from the proposal?
--Will the proposal enhance the broad competitive environment?
--Is the proposal consistent with national economic and social priorities?
--Does the proposal achieve or maintain equal competitive ground rules among various types of competing financial institutions, and does it provide opportunity for competitive financial institutions to maintain viability and profitability regardless of size?

We believe these questions should be asked of all banking legislation.

An attachment to this testimony attempts to provide answers to the questions as they relate to S.3304.

Our Association has been involved in research and discussion of the issues raised in S.3304 for some time. The following items have been submitted to this Committee on previous occasions and should prove useful in your discussions of this proposal.

1) ABA testimony before the Subcommittee on Financial Institutions of the Senate Committee on Banking, Housing, and Urban Affairs, on June 21, 1977. This testimony discusses NOW accounts, the Federal Reserve's membership problem, and S.1668, our Association's legislative proposal to deal with these issues.

2) ABA testimony before the Senate Committee on Banking, Housing, and Urban Affairs, on October 11, 1977, on the role of the Federal Reserve in providing payments services.

3) A letter from ABA to Senator Richard Lugar dated November 4, 1977, discussing the extent to which required reserves might be reduced for Federal Reserve member banks without impairing the effectiveness of monetary policy.
We have also attached to the testimony an outline of a research project the ABA will undertake to determine the impact of pricing of Federal Reserve services on the structure of the banking industry. This outline was part of a request for proposals that was sent to various consulting firms. We are currently in the process of evaluating their proposals and hope to begin the project soon.

The Central Bank and its Management of Monetary Policy

The need for mandatory universal reserve requirements on transaction accounts held by all depository institutions in order to assure an effective monetary policy has not been demonstrated. We oppose this proposal as unjustified and likely to harm our nation's innovative dual banking system.

The Fed has proposed universal reserve requirements on transaction accounts as a means of increasing the effectiveness of its monetary management. Nevertheless, it should be noted that the Federal Reserve does not have universal support for its view that reserve requirements are a necessary tool for monetary policy. It is our view that reserve requirements for existing Fed member banks could be significantly lowered, and the membership burden concomitantly relieved, without any significant diminution of the Fed's ability to conduct monetary policy. To achieve this within a framework in which the Fed retains maximum flexibility to use reserve requirements for monetary policy purposes, we propose that existing statutory minimum reserve requirements be eliminated. Our views on this point are amplified in the aforementioned letter to Senator Lugar.

It is true that the percentage of transaction accounts subject to reserve requirements of the Federal Reserve is declining. The decline of Federal Reserve membership is only one factor accounting for this. Another is the increasing proportion of transaction accounts that are held outside the banking industry. Differing levels of reserve requirements among member and non-member institutions
can cause additional instability in the money supply as deposit shares of these different categories of institutions change and money flows among them. But economists in the banking industry believe a much greater source of instability is the graduated levels of reserve requirements among banks who are already members of the Fed. Elimination of these differences would be a significantly greater contribution to monetary stability—and an act of simple fairness to the institutions involved.

As already stated, we believe reduction in reserve requirements should probably be the preferred method used to alleviate the current membership burden. However, if it is administered fairly, we do support proposals calling for the payment of interest on reserves. Indeed, the two methods can be considered complementary to each other.

Limiting the payment of interest on reserves to revenues received from the pricing of services would not alleviate the Fed's membership problem. "Free" services received by member banks now are only a very limited offset to the excessive burden of reserve requirements. If prices charged by the Fed approximate the value of services received, and interest paid is limited to revenues received from pricing, the excessive burden of reserve requirements will not be eliminated. The Fed could then try to alleviate its membership problem by raising its prices in hopes of increasing the revenue it has available to pay interest. But if its customers were price sensitive and looked for other providers of payments services, this probably would not work.

The gathering of additional information from non-member institutions, has our support, provided the data are needed for monetary policy purposes and proper safeguards are adhered to. In particular, the data gathering should be done in such a way that minimizes the burden placed on those institutions, and reasonable attention should be given to a realistic analysis of cost vs. benefits.
While we do not agree with all of the specifics of the various proposals to solve the Fed's membership problem, we continue to believe that, for the foreseeable future, a strong membership base is very important to the development of successful monetary policy and support for it. The problem is urgent and attention should be paid to it as soon as possible. We are acutely aware that the cost of Federal Reserve membership is an important item on the current agenda of bank board meetings all across the country. As Chairman Miller recently pointed out in hearings on this subject before the House Banking Committee, and as Secretary Blumenthal pointed out in hearings last year on S.1664 and S.1668 which dealt with the membership problem, the longer the problem continues, the more banks will withdraw from the system and Treasury revenues from that source will decline anyway. Limiting the options available to relieve the membership burden because of concern over current Treasury revenues could be penny-wise and pound-foolish. By the Federal Reserve's own estimate, withdrawals from the Fed since 1970 reduced Federal Reserve payments to the Treasury in 1977 by nearly $200 million from what they otherwise would have been. The problem is long run. It is structural. It is continuing. And it should be solved.

Enhancement of the Efficiency of the Payments System

We believe the efficiency of the payments system would be greatly enhanced if the Federal Reserve charged for its services. However, we must note that we foresee several difficulties in pricing of existing Federal Reserve services and the provision of new ones. The problem of determining proper cost allocations is difficult enough for private firms. If the Fed decides to take into account its own costs in setting its prices, as it most certainly should, the situation is substantially more difficult. How does one allocate overhead costs among such diverse activities as the administration of monetary policy through open market operations, the provision of services as fiscal agent for the Federal
Government, the supervision of state-chartered member banks, the regulation of bank holding company activities, and the provision of payments services which also can be provided by private banks? Even if all the relevant data were known, we can think of no way to do this on a rational basis. Indeed, as new payments systems evolve, it becomes more and more difficult to even know the relevant data.

The provision of payments services is the main banking area in which the Fed competes directly with the private banking system. Yet with 12 regional banks, each having several branches which serve primarily as operations centers, the Fed already has a nationwide system of operations centers in place. There is no way a single bank can match this capability under the current banking structure. This makes accurate comparisons of the public and private clearing systems more tenuous.

The proposal to limit payment of interest on reserves to revenue received from pricing could diminish rather than enhance the efficiency of the payments system. We have already discussed why it would not eliminate the Fed’s membership burden. Under such a system, the Fed might attempt to become more aggressive in providing new services in an attempt to raise pricing revenue so as to be able to alleviate more of the membership burden. Alternatively, if it believed its customers were price-elastic it could, to the extent Congress and its auditors permit it, undercut the private sector in an attempt to raise its revenues in order to pay more interest on reserves and achieve a greater alleviation of its membership burden. Neither of these responses would enhance the efficiency of the payments system, and it is not clear that either of them could ever enable the Fed to achieve an effective elimination of its membership burden.

We are somewhat dismayed by the Federal Reserve’s comment that if universal reserve requirements were enacted the Board would have to reevaluate its program
to reduce the cost burden of required reserves, and price its services. We believe the Fed should reduce the cost burden of reserves and price its services, regardless of the structure of reserve requirements among depository institutions. Such a program, if properly constructed, would greatly enhance the efficiency of the payments system without significantly diminishing its ability to conduct monetary policy.

It is our belief that an efficient payments system will be maintained only if there is a strong, healthy, market-oriented, private-sector alternative to payments services provided by the Fed. To insure this, we would propose two rules to which the Federal Reserve should be bound in setting its prices:

1. Fed prices should not be less than fully allocated costs, including all items of cost such as rent, depreciation, management and operating salaries, cost of capital, taxes, and the very significant cost of float—an item often neglected in discussions of this issue.

2. Fed prices should not be less than what the private sector would charge for similar services.

Although these standards would be difficult to enforce, they are not mutually exclusive, and both should be used in the evaluation of Fed prices. If this is done in a fair and impartial manner, the efficiency of the payments system will be greatly enhanced. Our testimony on this subject before your Committee on October 11, 1977, elaborates on this view. These standards will also insure the existence of a viable private sector alternative for the users of payments services, thereby enforcing market discipline and allowing for maximum innovation.

Because of the Fed's role as a government agency with privileges accorded to no private institutions, and the conceptual and practical difficulties in setting a price for its services, attention should also be paid to what services should be provided by the Fed as well as the price that should be paid for them. Only when this is clearly agreed upon and understood by the Fed, the Congress, and the private sector, can a fair and sensible balance be achieved between the
Federal Reserve and the private sector as providers of payments services.

Arbitrary Discrimination Among Financial Institutions

Chairman Miller has recognized the competitive inequity in the reserve requirements structure of member and non-member institutions. However, inequities which are just as harmful exist in the reserve requirements structure for existing member banks. In his testimony on this problem before the House Banking Committee Chairman Miller stated that his proposal for universal reserve requirements would not increase regulatory burdens on non-member banks. This statement neglects an important part of the picture. Many banks elect to have a state charter and to be non-members purely to avoid the excessive burdens of the Fed's reserve requirements—not because they dislike the regulatory administration of the Comptroller of the Currency or the Fed. Should universal reserve requirements be enacted, the ultimate value of many state bank charters would be substantially diminished and many banks would over time opt to join the Fed as a national bank. Rather than substantially change the relative value of state and national bank charters, a more sensible approach is to extend reserve requirements on transaction accounts to all federally chartered depository institutions, and to those state chartered institutions that elect to join the Federal Reserve, or the Federal Home Loan Bank Board. This proposal was made by our Association in S. 1668, in testimony before your committee last year. This alternative preserves the relative value of state and national bank charters in line with our Federal system. It extends the dual banking concept, as it is known in the banking industry today, to thrift institutions as they come into the payments business.

Limitation on total interest that may be paid on reserves unnecessarily restricts the Fed's options. We caution the committee to be sure that any such limitation is realistic, and does not excessively hamper the Fed in its attempt
to effectively relieve its membership burden. Setting a lower interest ceiling on required reserves over $25 million is discriminatory and we oppose it. Setting the maximum rates that can be paid far below the market is also obviously unrealistic.

These proposals seem to be inspired by the view that interest on required reserves would be a "raid on the Treasury" and would, unless controlled, constitute an unnecessary subsidy to larger banks. We disagree with both points.

Reserve requirements are a tool of monetary policy. If they are to be viewed as part of the Internal Revenue tax collection system, they should be considered in that context. The question of the impact of reserve requirements on Treasury receipts is a very complex subject. It depends overall on the level of the system holdings of earning assets in line with current monetary policy goals. Many other factors enter the picture, and have an impact on these goals. In the final analysis, the Federal Reserve can control the level of system reserves through open market operation.

Table 1 at the end of our testimony compares Federal Reserve payments to the Federal Treasury with total Federal budget receipts in selected years. Between 1957 and 1976 the percentage of Federal budget receipts accounted for by Federal payments to the Treasury rose over two hundred and forty per cent. The contribution of sterile member banks reserves to Federal Reserve earnings constitutes a significant proportion of the total earnings. The proportion may have declined somewhat because of the lowering of reserve requirements since 1957. But it has not declined significantly, and it seems safe to say that the contribution of sterile member bank reserves to federal budget receipts has more than doubled since 1957.

Proponents of the thesis that interest on reserves would be a "raid on the Treasury" have on occasion, pointed to the low effective tax rate paid by banks.
This emphasis is misplaced. Those banks that pay effective tax rates substantially below the statutory rate of forty-eight per cent do so because they take advantage of specific tax incentives designed to influence the allocation of their funds. The most important example of this is the tax exemption on municipal bonds—an exemption that has, for a long time, been basic to our constitutional system. In responding to the objectives of this exemption, banks forego the substantially higher income they might earn on taxable securities, and other alternative investments. In the process, however, these banks make a significant contribution to financing the needs of state and local governments. Another example is the investment tax credit, an incentive specifically enacted into law by the Congress for the purpose of job creation and capital formation. Through their leasing operations, banks make a significant contribution in this area.

Banks are proud of their record as taxpayers and deliverers of financial services. There is no justification for discrimination against any size class of banks, or against banks as institutions vis-a-vis their competitors.

Also, declines in Federal Reserve payments to the Treasury because of reduced reserve requirements could easily be mitigated by a gradual phase-in of the program to relieve the membership burden. Of course, this would mean that it might take longer to achieve a significant alleviation of the membership burden. Nevertheless, knowledge that positive steps are taken to relieve this burden would probably stem the membership attrition in a substantially shorter period of time.

The Federal Home Loan Bank Board is frequently viewed by thrift institutions, who are major competitors of most banks, as its "central bank" which performs many of the functions for its members that the Federal Reserve performs for its members. Members of both systems supply funds to the "central bank" and in turn receive a return on funds supplied. Table 2 provides estimates of this return. For banks in the Federal Reserve system the return is 2.0 per cent--
mainly an imputed return from the cost of Federal Reserve services. For thrift institutions in the Federal Home Loan Bank System the return is 4.3%.

Finally, we would like to note that, although we have no objections to payments from the Fed's surplus to the Treasury, as proposed by the Fed, the "surplus" does not represent idle cash or current earnings but merely an accounting entry that arises because past earnings from the use of required reserves or the provision of coin and currency have been retained and invested in other assets.

In summary, we believe the current discriminatory aspects of the reserve requirements structure are unfair and unnecessary. We oppose the compounding of this problem by additional discrimination in the interest rate paid on reserves. The emphasis being put on the relationship between Treasury revenues and the membership burden in misplaced and, in the long run, will be detrimental to both the Fed and the Treasury. The efficiency of the payments system would be greatly enhanced by explicit pricing of Federal Reserve services in a manner that recognizes the constructive and innovative role played by the private sector in the provision of payments services. Such explicit pricing must be accompanied by an effective alleviation of the Federal Reserve's membership problem. The most promising way to do this is to reduce reserve requirements. We also support fair and impartial methods of allowing banks to earn interest on their reserves.
<table>
<thead>
<tr>
<th>First Year</th>
<th>Payments to Treasury by Federal Reserve</th>
<th>Federal Budget Receipts</th>
<th>Federal Reserve Payments to Treasury as a Per cent of Federal Budget Receipts</th>
</tr>
</thead>
<tbody>
<tr>
<td>1957</td>
<td>543*</td>
<td>79,990</td>
<td>.67%</td>
</tr>
<tr>
<td>1962</td>
<td>718</td>
<td>99,676</td>
<td>.72</td>
</tr>
<tr>
<td>1967</td>
<td>1,805</td>
<td>149,552</td>
<td>1.21</td>
</tr>
<tr>
<td>1972</td>
<td>3,252</td>
<td>208,649</td>
<td>1.56</td>
</tr>
<tr>
<td>1977</td>
<td>5,908</td>
<td>356,861</td>
<td>1.66</td>
</tr>
</tbody>
</table>

Source: Treasury Bulletin

*Calendar Year 1957
Table 2
Return on Funds Supplied by Member Institutions to the Federal Home Loan Banks and the Federal Reserve Banks

<table>
<thead>
<tr>
<th></th>
<th>Federal Reserve System (Millions)</th>
<th>Federal Home Loan Bank System (Millions)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Funds Supplied by</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Member Institutions</td>
<td>24,088</td>
<td>7,438</td>
</tr>
<tr>
<td>Capital Stock (millions)</td>
<td>1,029</td>
<td>3,295</td>
</tr>
<tr>
<td>Reserves</td>
<td>26,709</td>
<td>0</td>
</tr>
<tr>
<td>Deposits</td>
<td>0</td>
<td>4,143</td>
</tr>
<tr>
<td>(less float)</td>
<td>3,650</td>
<td></td>
</tr>
<tr>
<td>Return on Funds</td>
<td>490</td>
<td>321</td>
</tr>
<tr>
<td>Dividends</td>
<td>60</td>
<td>146</td>
</tr>
<tr>
<td>Interest on Deposits</td>
<td>0</td>
<td>175</td>
</tr>
<tr>
<td>Services (at cost)</td>
<td>430*</td>
<td>0</td>
</tr>
<tr>
<td>Percentage Return on</td>
<td>2.0%</td>
<td>4.3%</td>
</tr>
<tr>
<td>Total Funds Supplied</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

*Federal Reserve's estimate of the cost of providing check clearing (including ACH) and coin and currency services.

Analysis of S. 3304

How do bank customers benefit from the proposal?

The extension of reserve requirements to non-member banks would hurt those banks and diminish their ability to serve their customers. Customers of banks that achieved a significant relief from the membership burden would benefit. Others would not. The proposed limitation of interest on reserves to revenues received from pricing would probably diminish the efficiency of the payments system and harm bank customers.

Will the proposal enhance the broad competitive environment?

The pricing of payments services by the Fed would, if done properly, enhance the efficiency of the payments system and the broad competitive environment between public sector and private sector providers of payments services. However, the proposal to limit interest payments on reserves to revenue received from pricing would diminish the efficiency of the payments system and detract from the broad competitive environment by encouraging the Fed to pursue counter-productive policies in the pricing and provision of payments services.

Is the proposal consistent with national economic and social priorities?

The proposal would facilitate some alleviation of the Fed's membership problem and give the Fed greater control of reserves for monetary policy purposes. However, our testimony elaborates on several undesirable aspects of the proposal, and we believe there are more efficient ways to achieve the objectives of the bill.

Does the proposal achieve or maintain equal competitive ground rules among various types of competing financial institutions, and does it provide opportunity for competitive financial institutions to maintain viability and profitability regardless of size?
The ability of smaller non-member banks to compete would be diminished by burdening them with excessive reserve requirements. The bill recognizes this by exempting the first $5 million of transaction accounts from reserve requirements. But there is still no reason to impose additional burdens on larger non-member banks. Some competitive inequities would be corrected by setting reserve requirements on transaction accounts at non-bank depository institutions. The proposal would discriminate against medium-sized and larger institutions on the payment of interest on reserves and the substantial inequities in the existing reserve requirements structure would be continued. Our testimony suggests some equitable ways to resolve these difficult issues.
Outline of Project to Estimate the Impact of the Pricing of Federal Reserve Services

I. Purpose - To develop alternative scenarios for the pricing of Federal Reserve services and estimate their impact on the Banking industry.

II. Parameters of the pricing process

A. Services to be priced. ABA task force says that all Fed services should be priced. These would include such things as:
   1. Check collection services
   2. Automated clearinghouse services
   3. Wire transfer services
   4. Coin and currency services
   5. Net settlement services
   6. Securities safekeeping services
   7. Bank examinations
   8. Services provided to other governmental agencies
   9. Any new services provided

B. Factors to be considered in determining prices:
   1. What is to be done about membership burden
      a. Interest on reserves
      b. Reduction in reserve requirements
      c. Government securities held as reserves
      d. Nothing done to relieve membership burden
   2. Cost factors
      a. Cost concept used
         (1) Fully allocated Federal Reserve costs, including cost of capital and taxes
         (2) Something less than fully allocated Fed cost
            a) Marginal cost
            b) Average operating cost, no allocation of overhead
(3) Costs that would be incurred by the private sector if they performed the service

(4) Costs are ignored, membership burden is relieved by one of the methods stated above, and prices are set so as to have zero gain, or loss, to Treasury

b. Other cost distinctions

(1) Fed district
   (a) Uniform price schedules in all Fed districts
   (b) Price schedules depend on operating costs of Fed district

(2) Usage of services
   (a) Volume discounts
   (b) No volume discounts
   (c) Others—e.g., are there economies in the joint usage of particular services?

(3) Geographic location of bank
   (a) Prices uniform across country or, at least, within Federal Reserve District.
   (b) Prices vary according to the location of the bank

3. Other dimensions of pricing problem

a. Access

(1) Priced services available to all depository institutions

(2) Priced services available only to member banks

(3) Current access rules are maintained/i.e., services which are currently provided to non-members will be provided to them under a pricing regime. No new services will be provided to non-members.

b. Availability—i.e., how quickly is the service provided

   (c) Others?
III. Factors affecting bank structure

A. Ability of correspondents to pass on added costs to respondents.

B. Responses of respondent banks to the added costs that are passed on.

C. Extent to which measures taken to relieve membership burden would offset added charges and negate the need correspondent banks would feel to pass on added costs.

D. Extent to which private sector will develop new payments systems outside the Fed.

E. Responses of member and non-member banks to the development of such systems. How would these responses affect the membership question?

IV. What is to be done?

A. A matrix of prices is to be developed. The matrix should show the prices for the services listed in part IIA under the different pricing scenarios that could be delineated using the factors listed in IIB.

Note: We understand that some of the data needed to develop the cost estimates will be internal Fed data that we do not have access to. However, a fair amount of cost data is published by the Fed. It will be the responsibility of the consultant to use this data in conjunction with other available data to develop the best possible estimate of the costs.

B. The effect of each of the pricing scenarios on bank structure is to be evaluated. Some possible factors to be considered are listed in part III. The consultant may suggest other factors.
The CHAIRMAN. Thank you very much, Mr. Perkins.
Mr. Bolger.

STATEMENT OF THOMAS F. BOLGER, PRESIDENT, McHENRY STATE BANK, McHENRY, ILL., AND SECOND VICE PRESIDENT, INDEPENDENT BANKERS ASSOCIATION OF AMERICA, ACCOMPANIED BY RICHARD PETERSON, CONSULTANT

Mr. Bolger. Mr. Chairman, my name is Thomas Bolger. I am second vice president of the Independent Bankers Association of America, and president of the McHenry State Bank, McHenry, Ill.

I appreciate the opportunity to appear before this committee on behalf of the 7,300 members of IBAA to present our views on the proposals relating to the payment of interest on reserves held by the Federal Reserve banks and the explicit pricing of Federal Reserve System services.

IBAA is comprised of a large number of relatively small community banks. More than 80 percent of our banks have assets of $25 million or less and over two-thirds are located in towns of under 5,000 population. Most of our members are found in the middle third of the country comprising the major agricultural States, consequently our banks are deeply involved in meeting the credit needs of agriculture, small business, rural housing, and the consumer. In 1976, for example, commercial banks with assets of $25 million or less supplied almost half the credit extended to agriculture by all of the Nation's commercial banks. Thus, by supplying a major share of bank credit to rural communities, our banks make a considerably larger contribution to the Nation's economic well-being than their size and share of commercial banking assets might suggest.

We appreciate the opportunity to testify on the proposed legislation to enable the Federal Reserve Board to pay interest on reserves held at Federal Reserve banks and to sanction the payment of explicit charges rendered depository institutions by the Federal Reserve System. However, I should point out that the constraints imposed by the timing of these hearings has limited our ability to assess fully the effectiveness of these proposals, in conjunction with the numerous proposals daily appearing in the House, in stemming the attrition of Federal Reserve System membership and their impact on the banks comprising our membership.

We share the concern of the Federal Reserve Board's chairman that attrition of both banks and deposits of membership in the Federal Reserve System has accelerated in recent years and that the failure to halt membership attrition may have severe implications for the ability of the Federal Reserve Board to conduct monetary policy. However, we are not persuaded that legislative remedies proposed by the Federal Reserve Board will provide the necessary inducements to attract nonmembers to join the Federal Reserve System or persuade members to remain in the system.

Let me turn, then, to the specifics of the legislation being considered by this committee. Title I would amend the Federal Reserve Act to provide for the maintenance of reserves against transaction accounts in Federal Reserve banks by all federally insured depository institutions.
It is, in effect, a mandatory universal reserves statute requiring commercial banks, mutual savings banks, savings and loan associations, and credit unions to maintain reserves at Federal Reserve banks against demand deposits and all other transaction accounts. The bill would exempt from the reserve requirements, subject to such rules and regulations as may be adopted by the Board, the first $5 million of transaction accounts of a depository institution. Reserves meeting the statute's requirements are to be in the form of balances in the Federal Reserve bank of which it is a member or at which it maintains an account; or balances maintained by a nonmember depository institution in a member bank or in a Federal home loan bank maintaining such funds in the form of balances in a Federal Reserve bank of which it is a member or at which it maintains an account.

IBAA has long been opposed to legislation which would make it mandatory for all banks to maintain reserves in the Federal Reserve System. Although national banks comprise about 27 percent of IBAA's membership, 73 percent are State chartered banks, of which a small minority are members of the Fed. State chartered banks favor the freedom to join or not to join the Federal Reserve System. Furthermore, the exemption purportedly provided for the first $5 million in transaction accounts is purely illusory in that there is broad statutory authority given the Board to impose reserves on even these deposits. It is our deep concern that the mandatory reserve requirement would superimpose Federal regulation over State chartered depository institutions and so erode State regulations as to ultimately lead to complete Federal control.

Momentarily, skipping over to title III, it would authorize the payment of interest on reserve balances held in any Federal Reserve bank. It would authorize the Federal Reserve banks to pay a total amount of interest in any 1 year up to the sum of: (a) total receipts from the recipients of such interest for services rendered by Federal Reserve banks; and (b) 7 percent of the total net earnings of the Federal Reserve banks computed without regard to the payment of such interests; but with a ceiling rate of 2 percent per annum on reserve balance in excess of $25 million. As to the latter (b), the Board is now seeking deletion of this section. The cost to the U.S. Treasury of such interest payments could be a very high price to pay to induce State chartered depository institutions to become members of the Federal Reserve System. There is no assurance that the rate of interest to be paid on reserves will constitute sufficient inducement for nonmember institutions to join the Fed or to enjoin Fed members from defecting. A strong case has not been made to demonstrate that the payment of interest on reserves as proposed will, in fact, solve the problem of attrition.

Since the purpose of the payment of interest on reserves held at the Fed is to make Fed membership more attractive and halt membership attrition, the amount of income derived from such payment would have to be equal to or exceed the earnings on reserves presently available under State reserve regulations. A recent study of the burden of Fed membership revealed that the heaviest burden is borne by member banks with deposits under $100 million and that banks with deposits over $1 billion appear to experience a net benefit from system membership. Thus smaller member banks may operate at a competitive dis-
advantage relative to the larger ones. This suggests that unless interest payments on reserves are equated with the burden of membership, interest payments are not likely to be an effective instrument to attract new members or in reducing membership attrition.

The lack of precise data on the net costs of this proposal to the Treasury leads us to urge caution in setting the permissible interest rate limits too high. On the other hand, the setting of rates of return on reserves too low would make membership unattractive and thus defeat one of the basic purposes of the legislation.

To return to title I, it also requires the Board to prepare and offer for public comment a set of pricing principles and a proposed schedule of fees for Federal Reserve System services. The regulatory proposal to make explicit charges for Fed services could create problems for small member banks, that is, those with assets of $25 million or less. Most of these banks would be exempt from the reserve requirements and presumably, under our reading of the statute, would not be receiving any interest payment from the Fed on their transaction balances. However, they as members would be assessed charges for services provided by the Fed. Under these circumstances small banks are not likely to be attracted to membership in the Fed since they would probably opt for obtaining these services through their correspondent banks. Fed services may be attractive but if a bank can obtain all of those services plus many more from its correspondent it would be sacrificing earnings to be in the system. The only unique service offered by the Fed is access to the discount window but a large number of banks have found that this service is not an adequate inducement to remain members.

The effect of the payment of service charges on small banks is difficult to predict since it cannot be determined whether they would continue to obtain most of these services through their correspondent banks as an offset against compensating balances or whether the correspondent banks would pass these explicit charges through to their respondents in addition to the income earned on compensating balances. It seems certain that correspondent banks would be likely to adjust their compensating balance requirements upward to pass through some of the explicit charges assessed against them by the Fed for services. Thus small banks are not likely to obtain any benefits from the payment of interest on reserves but could be required to pay more for services performed by the Fed.

The thrust of the proposed legislation appears to be directed at holding in the Federal Reserve System the 1,003 State chartered members of the system and inducing the remaining 8,600 State chartered nonmember banks to join the system. Most nonmember State chartered banks are relatively small institutions as revealed by the fact that in 1976 there were 11,800 banks with assets under $50 million accounting for 82 percent of all banks in the United States. If, as some studies have shown, small banks bear a heavier burden of Fed membership than larger banks, the inducements offered to the smaller banks to join or retain membership in the Fed should take account of these differences.

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of membership burden. We do not believe the proposed legislation meets this requirement.

Although we realize the Senate does not now have before it the alternatives being considered in the House, they will undoubtedly surface here eventually and IBAA would like to take this opportunity to comment on several of them. First, H.R. 12706 which would provide for the pricing of Federal Reserve System services and the payment of interest on reserves, attempts to give sufficient study to the proposal before putting it into effect—of course this implicitly precludes any prospect of explicit pricing until the studies are concluded. While authorizing the Fed to pay interest or reserves the bill requires the Board to prepare a feasibility study and transmit it to Congress not later than July 1, 1981. We believe this is a constructive approach.

H.R. 12706 will hamstring the Fed in pricing services by mandating explicit pricing to include both direct and indirect costs. This could make membership very unattractive, especially if the Fed could not respond to market pressures caused by other correspondents providing like services.

The amendments proposed by Chairman Reuss to H.R. 12706 seek to address some of the concerns we have identified above. First, by reducing the amount of interest to be paid to income and earnings, there would be no drain on the U.S. Treasury. Second, there would be no universal reserve requirements imposed on nonmember banks, and there would be a statutory exemption of the first $10 million in transaction accounts, both consistent with the goal of reducing the burdens of membership and enhancing the competitive posture of small independent banks. Third, a universal reporting requirement would be imposed to provide current and reliable information in order to effectuate monetary policy. We question whether or not an enhancement of the current reporting program involving nonmember banks will provide all the information necessary without imposing a new regulatory paperwork burden on small banks.

On the other hand, we believe more attention needs be given to the proposed amendments which wrenches from the Fed the flexibility to set reserve requirements and the discount rate.

Indeed, the proposals before this committee are a mixed bag of monumental import.

On balance we cannot endorse S. 3304 since we are not convinced that they will achieve the stated objectives. Furthermore, we are not convinced that such legislation is necessary to prevent system attrition or that the Fed’s ability to manage monetary policy requires that all depository institutions maintain reserves in the Fed. To improve the Fed’s capability to manage monetary policy it may only be necessary to authorize it to obtain summary statistics on assets and liabilities of all depository institutions as proposed in an amendment to H.R. 12706. Another proposal, short of the sweeping proposal of the Fed which warrants consideration, is that offered by the Board of Directors of the Federal Reserve Bank of Kansas City. This proposal would allow member banks to invest a portion of their required reserves in Government securities owned by the Federal Reserve. Individual banks would be allowed to choose specific issues from the variety of maturities in the Federal Reserve’s portfolio of U.S. Government securities. All pur-
chases and sales of securities for reserve purposes would be made with the Federal Reserve at money market prices. The securities would be held by the Federal Reserve in a safekeeping account maintained for reserve purposes. The proposed amendment requiring a feasibility study of such a proposal seems appropriate.

Another proposal suggested the creation of a new type of “affiliated” membership, which would make membership more attractive particularly to smaller banks, by reducing some of the burdens of membership. Under this proposal the requirement to purchase stock in the Fed would be eliminated; access to the discount window would be provided at a rate above the charged full members; and the reserves required would be based on a clearing formula but not above those requirements for members.

At this juncture we feel that the point and counterpoint that seems to be rushing this legislation along ought to be resisted. We feel the issues have been blurred and the net losers will be those who are intended as beneficiaries important questions need to be asked such as whether the immediate goal is to enhance Fed membership or to provide the Fed with the tools necessary to effectuate monetary policy. Some of the proposals seem to be at cross purposes. In short, what is the rush?

If Congress is concerned that the Fed may take precipitous action in the event no legislation passes before the end of the session, the answer to us is to pass a resolution putting this first on next year’s agenda while prohibiting any implementation. There will be time to have the Congress, the Fed and all the various interest groups analyze the impacts and identify unreasonable courses of action.

We believe that if the Fed is sincere in enhancing membership, there is one free way to do it. Over the years many members of our association have gotten the impression that there is a deep seated Fed attitude of disregard for the problems of small independent banks. These attitudes have been manifested in a number of ways. In a study done by the House Banking Committee it is clear, for instance, that the boards of the district banks are heavily weighted in favor of individuals sensitized to big banks, rather than small banks. Furthermore, historical review of the administration of the bank holding company act suggests a non-recognition of the importance of this corporate structure as a means of transferring small bank ownership from one set of owners in a community to another set also in that community. In short, you can catch more flies with honey than with vinegar.

If there is any message that we urge on the members of the committee today, it is to go slow. Certainly, it is appealing to many of our member banks to receive interest on reserves. Yet a concern of the unknown—pricing—suggests caution. If the Congress would seek to enhance membership rather than just give the Fed the tools necessary to effectuate monetary policy, all the costs should be known. We have not seen the specific proposals, and we understand the committee has not either. If a package of proposals will achieve the result, they should all be carefully studied—not rushed through. The vast majority of our member banks are the purported beneficiary of these proposals. They have not had a chance to understand what has been pro-
posed, much less respond to either us or the committee directly. In all fairness, they need the chance to reflect and we urge you to give them that opportunity.

Our doubts as to the efficacy of the proposed legislation in meeting the attrition problem are heightened by the facts revealed in a study analyzing Federal Reserve System attrition since 1960. That study found the principal factors contributing to Fed attrition to be a tendency of de novo banks to remain outside the system; and a pattern of more mergers and absorptions of member banks than nonmembers with most of the merged and absorbed banks having been acquired by other member banks. The bulk of deposit attrition has been due to a more rapid rate of internal deposit growth on the part of the nonmember sector (including the growth of de novo nonmember banks chartered since 1960), resulting in a relative increase in the average size of nonmember banks.

The study concluded that without any reduction in the burden of Fed membership, the pattern of net system withdrawals, as well as the preference of de novo banks for nonmember status, may be expected to continue. Moreover, recent withdrawals of member bank subsidiaries by several multibank holding companies portend increased withdrawal activity on the part of multibank holding companies. Given the larger size of multibank holding company member banks, such an increase in withdrawal activity could mean a further acceleration of deposit attrition. To slow and possibly turn around the pace of aggregate deposit attrition the burden of System membership according to the study must not only be eliminated but must be converted to a net benefit in order to encourage both ongoing nonmembers and de novo banks to join the system. Our analysis of the proposed legislation leads us to the conclusion that it will not meet this test.

The CHAIRMAN. Thank you, Mr. Bolger.

Mr. Perkins, your preferred solution to the Federal Reserve problem is to lower reserve requirements and to permit interest to be paid on reserves. You oppose universal reserve requirements that many people have endorsed and others believe would be a fair and equitable solution.

If universal reserves carried with it a large exemption for banks below $50 million in deposits and if they also carried with it a reduction in the reserve requirements below what they are now, which is what both Chairman Miller and others have proposed, would you find them more attractive?

Mr. Perkins. Well, obviously they would be more attractive in a sense. We have some trouble with the idea there should be size discrimination in reserve requirements, depending on the size of the bank, but leaving that question out—

The CHAIRMAN. Well, there is now. There has been consistently.

Mr. Perkins. I know there has.

The CHAIRMAN. We have always provided for lower reserve requirements for smaller banks.

Mr. Perkins. I think the point I made in the testimony is that we can see some kind of a required reserves, interest on reserves, and pricing

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as a package for all federally chartered depository institutions as being one way to get at the equity issue and the broader issue. We have trouble with eliminating the alternative of the State charter, and this goes back to the whole question of the dual banking system in this country. It is based on the federal system we have, and we believe that while you can argue for a perfect symmetrical equity, there's a lot to be said for maintaining the federal system in the country with its checks and balances and its options.

The CHAIRMAN. Well, why would the universal reserves necessarily do away with State charters? I can't understand why you can't have a system in which you have the same reserves required for all banks the same size, the same deposits, but that you have the State chartering banks that choose to go that way and the supervision and examination and so forth still lodged in the States so you still would have a dual system.

Mr. PERKINS. Well, I think one answer would be very clear and that is a lot of State-chartered banks wouldn't bother to be State chartered. They would switch to a national charter if they were exempt from reserve requirements and they got some access to whatever services they wanted.

Mr. HAYWOOD. Mr. Chairman, if we take Mr. Miller's proposal of yesterday of exempting banks under $50 million from reserve requirements, what State bank would then stay in its State system, where it would have to meet State requirements, if it could get zero reserve requirements by converting to a national charter? Mr. Miller's proposal is really to nationalize the system, to provide inducement for all banks to convert to national charters.

The CHAIRMAN. Well, I don't know why they would necessarily switch, to put it the other way. The State reserve requirements are pretty gentle. They permit the reserves to be kept in earning assets, as you know.

Mr. HAYWOOD. It varies from State to State.

The CHAIRMAN. Well, most States do. They don't all, that's true, and I think there might well be a modification in the States that permit that.

Mr. HAYWOOD. May I say we looked at this very quickly yesterday. We looked at a few States in terms of their reserve requirements. The association certainly intends to explore this most thoroughly in the days that lie ahead, but we came to a conclusion that there would be substantial incentive to shift from State charters to national charters because you would be shifting from something positive in the way of reserve requirements to a zero reserve requirement.

The CHAIRMAN. Well, after all, shifting isn't just something you do like that based on a theory or a whim, as you know. You do it with considerable concern. It's costly to shift. You have to change the name. You have to print forms. That's minimum action. And I think you find if you shift, you make a decision that would in most cases last for a number of years. You wouldn't want to shift and then come back again—that's like firing Billy Martin and saying, "Come back in 2 years."

Mr. HAYWOOD. Or Mr. Allen.

The CHAIRMAN. Or George Allen. That's right.
Mr. Haywood. He has suffered some of that same thing.
The Chairman. Not only we in Washington but those in Los Angeles were concerned about George, but apparently that's more universal.

Well, as I say, I do think this is a matter that is much deeper than simply allowing an advantage in reserves and, as I say, the advantage would be pretty small and mild. I notice that the first witness we had this morning, the banking superintendent of New York, Ms. Siebert, said—and she would have great concern and expertise in this area—she and the expert who accompanied her agreed if you had the $50 million exemption, you wouldn't have very much trouble with this with the universal reserves.

Mr. Haywood. I think, with all due respect, sir, these proposals are so new that very few people have had a chance to think through all the implications, and the one we are emphasizing here this morning is the one that concerns us most. We can't say how large that effect would be, but we do see that the direction of the effect would be to shift banks from State charters to national charters. Quite frankly, we think that our objective should not be to make large shifts in the structure of our system today, but should be rather to look for improvements and not disruptive things.

The Chairman. I agree with that. One of the other standards we'd like to maintain is the one Mr. Perkins properly set forth in his statement when he said you want to do this with the lowest possible cost to the public. The lowest possible cost to the public, of course, means that we maintain to the extent we can the Federal Reserve's contribution to the Treasury, that we don't erode that too much, and obviously if we are going to pay interest on reserves, that reduces the Federal Reserve's earnings and it reduces what goes back to the Treasury. It increases the general burden on the taxpayer and it gives banks an advantage which—if I were a banker and if I were president-elect of the American Bankers Association—I would be fighting for, too.

Mr. Perkins. Well, it's an enormous penalty on member banks and it's much larger than often computed because it's not being computed at the market rates. The point I was trying to make is that we never thought of the Federal Reserve System as a tax collecting operation, but when you get all done with the whole theory, the transitional changes and the rest, the real income from the Federal Reserve comes from the total earning assets they hold, total reserves in the system, and it's the percentage of that that the Treasury gets as its receipts from the Fed.

Certainly if you're going to pay interest on reserves, you're going to have some increased cost. However, we are presuming a lot of that is going to be offset by charges for services, too.

The Chairman. Well, it's a step we should take with considerable caution. We have never done it. We have been able to survive as a Nation for 200 years without it. The Federal Reserve System has been in operation for 65 years without permitting interest to be paid on reserves, and you can understand the very tempting populist appeal for anybody in public office to say we don't want to give away the public weal to the bankers. I mean, it's tough enough to resist welfare payments and payments to farmers and food stamps and so forth.
When we have to have a food stamp program for bankers, that is hard to support.

Mr. Haywood. I think we agree with a lot of that. That’s why we suggested lowering of reserve ratios over a period of time as an approach to solving the membership problem. We’d rather not get into the payment of interest.

The Chairman. I think that’s much better.

Mr. Perkins. And that’s a phase-in operation.

The Chairman. And I would agree bank earnings have not been adequate. I think they should be improved. It’s one of the problems we have in this country. The capitalization of our banks, small and large, is inadequate. We have to increase the profitability, but I think this is probably the less sensitive thing to do politically. It’s something that’s going to be very hard to sustain. You’re going to be constantly under attack by me and other guys.

Mr. Perkins. We thought we were already.

The Chairman. Mr. Bolger, you said 80 percent of the IBAA members have assets of less than $25 million. If universal reserve requirements were legislated with an exemption of $25 to $50 million in deposits, most of your members wouldn’t be affected. They wouldn’t be affected adversely. They would be benefited, if anything.

What would your reaction be to that kind of proposal?

Mr. Bolger. Well, of course, this would be a personal observation because these numerous proposals are just coming out, I think yesterday, and our association has not been able to act on them. Yet on the surface some seem like great things. They might be a bonanza. But, after all, bankers are people too. We must ask: Is it good for the country? And I’m not so sure that eliminating all reserves for that big a percentage of the banks is in the best interest of the country.

The Chairman. Would you be in favor of that kind of an exemption?

Mr. Bolger. I’m not sure that we would. Our association has not had a chance to take a position. These proposals just came out. But I say individually I think that—

The Chairman. I’d be pretty surprised if on consideration that your people wouldn’t favor that exemption.

Mr. Bolger. Well, my bank is a State Fed member. Our reserve requirement in the State of Illinois—Illinois has no State reserve requirements for State nonmember banks. We are required to keep a balance of $3.6 million with the Fed which at today’s returns is probably $250,000 or $300,000 return.

In answer to your question, sure on the surface it sounds great; but I think it would erode the dual banking system and I wouldn’t speak for the association and say that we would be entirely in support of that proposal.

The Chairman. In your statement you said that interest on reserves may not solve the membership problem and I agree. Can you explain that statement? And also, what do you think would solve the membership problem for the Federal Reserve?

Mr. Bolger. I really don’t know what would solve it. I think the thing that won’t solve it is moving too quickly with legislation. I think
there’s too many new proposals. I don’t think that there is any critical necessity to enact legislation.

The Chairman. In your statement you indicate your sensitivity to the pressure the Federal Reserve feels. They feel that their membership is dwindling and therefore their monetary policy power is eroded. They feel they have to act and they are putting pressure on us. They say if the Congress doesn’t act they may decide to act or feel they can act unilaterally. So that’s the urgency involved. They are concerned about our sitting and studying this for several years and finding their membership has dropped so sharply that it’s going to be very hard to recover.

Mr. Bolger. Let me refer to our legislative assistant.

Mr. Peterson. Well, Senator, I think that what we are talking about is a delay of some period so that people can conjugate what we’re talking about. There are many, many pitfalls that are involved.

The Chairman. How long a period would you say?

Mr. Peterson. Well, I would say, first of all, we would like to get some kind of an idea on all this explicit pricing business. Nobody has seen word one yet and we get very, very concerned over the entire issue of explicit pricing. I know that Governor Coldwell has promised Chairman Reuss to come up with some kind of a tentative pricing list by the end of the month, but I will assure you that there’s going to be extensive debate over that.

The Chairman. I think you’re right about the complications of the pricing system, but that doesn’t have to be part of this. That can be an entirely separate issue. I think we all agree it’s a healthy thing to consider it and probably to move in that direction.

Mr. Peterson. There is, I think, exactly what the American Bankers Association said, and this is not an association position at all, but I think from my personal point of view it’s transparent that the easy way to solve this whole thing is simply to reduce the reserve range and then tell the Fed to go ahead and do it. That’s it. People will come back in if they don’t have that burden.

The Chairman. The statement by Chairman Miller indicated that that wouldn’t be a satisfactory solution. It doesn’t give them enough latitude now and if they simply had to work with the limited number of members and their membership dwindling it would be much harder to have an effective monetary policy. Reducing Federal Reserve reserve requirements would be, in his judgment, no comprehensive solution to this problem.

Mr. Bolger, universal reserve requirements need not mean mandatory membership or any change in supervision and regulation of nonmember banks. Would you agree that universal reserve requirements need not change the current regulatory balance?

Mr. Bolger. I don’t think I understand the question.

The Chairman. Well, the point Mr. Perkins made was that if we have universal reserve requirements there would be no real incentive for the nonmember banks to remain outside the system. They could switch to a Federal charter. They could join and be exempt from reserve requirements.
Mr. Bolger. I agree with that and that's one of the objections. It would put a great strain on the dual banking system.

The Chairman. Well, I'm not so sure why. The reserve requirements are one element in their decision to be a member or nonmember. It's certainly not the only element by any means. But you think this is the decisive element?

Mr. Bolger. Well, if we're eliminating so many banks, as some of these proposals do, from any reserve requirements, and the way I understand it the Federal Reserve requirements apply over the State requirements, that it would certainly seem that many of the banks would take out Fed membership. They would not have to change their name to do that. Nonmember banks can apply for membership.

The Chairman. Mr. Perkins, you recommend payment of interest on reserves. If there were no membership problem this issue might not arise at all except the reserves are partially clearing balances, like balances banks hold with their correspondents. Why shouldn't this issue be taken up in the context of removal of the prohibition against interest on demand deposits and not until then? After all, when a bank like the McHenry Bank—and you may be the correspondent for them—when they put the correspondent balance on deposit with you, you don't pay any interest on it.

Mr. Perkins. No; that's true, but in return for the balances—and I think this needs emphasis in connection with some of your previous questions—the balance is paid for by services rendered and those services rendered are priced very explicitly and the balances, in most cases, of most of those correspondent banks, corporations, and others are very closely monitored to be sure they are paying enough for the service.

The Chairman. Whether they are closely monitored or not, there's the same kind of situation with the Federal Reserve and that, I suppose, is a calculation that many bankers enter into to determine whether or not they should continue as members of the Federal Reserve. They, too, get services; do they not?

Mr. Perkins. They get services, but I should say—I'll take my own bank, for example. Our average reserve requirements run about $550 million and we think on average it would only take about $100 million to pay for the services at market rates that we are using of the Fed and we are a very large user of the Fed system. I think one of the comments, Mr. Chairman, on the question—

The Chairman. Nevertheless, don't you see the analogy? Why shouldn't we consider this whole thing together? You're both cautioning that we take a little time with this and why shouldn't we consider this together with the removal of the prohibition against interest on demand deposits? We're moving in that direction. We have NOW accounts, as you know, in New England and moving across the country.

Mr. Perkins. Well, that's a possibility. On the other hand, I'm not so sure that there aren't some interim solutions like reducing the level of reserves and giving Chairman Miller a chance to find out whether he is right or wrong in terms of what that would mean to membership in the system, rather than just postulate the issue. But the fact is that
people are very conscious of the cost of idle reserves at the Fed and the problem is here and it's here now.

Mr. Peterson. Senator, I think I'd like to interject on this point. I think a great deal of the discussion that we're having and have been having for the last several years centers on this matter of how efficient we're going to make the financial system by changing to an explicit price mode. All I can see down the road is an absolute morass.

The Chairman. If you have an explicit price system with competition, why? You're the first witness who's indicated that. Every other witness has indicated this would be desirable. You may be right, but you're alone.

Mr. Peterson. I have to say that the Independent Bankers Association—and I'm now speaking for the association—is very, very skeptical of explicit pricing. Right now the genius of the system is that it's somewhat self-adjusting. We can adjust in terms of inflation and so forth, and there's an inherent problem in the explicit pricing of money.

The Chairman. I can't understand why, if you have competition, vigorous competition between the Fed and the big independent banks—the big banks who can offer services, too—why that competition shouldn't result as it always has in this country in more efficient operations and therefore lower cost operations, and I also can't understand why the bank shouldn't be charged full cost for their services.

Mr. Peterson. But we do. I think we have a——

The Chairman. What would be wrong with an explicit pricing system?

Mr. Peterson. It's an extraordinarily complicated thing. The financial industry has had experience with one mode of explicit pricing so far and it's called the Truth in Lending Act.

The Chairman. You say that as if you had just had a spike driven through your heart. I was author of the Truth in Lending Act.

Mr. Peterson. Every day I feel the spike.

The Chairman. I thought that was a pretty good bill. The Federal Reserve study indicated our consumers are now far better informed than they were before the Truth in Lending Act came into effect by three or four times as informed—three or four times the people now understand what the cost of credit is.

Senator Riegle. Mr. Chairman, would you yield at that point?

The Chairman. Yes, indeed.

Senator Riegle. Not only that, but the banks have done very well. They've got an enormous share of the market taken away from the high-cost lenders that previously had that, so I would have thought the banks would be here thanking us for that.

The Chairman. I wanted to be the banks' pinup boy for that reason but I haven't succeeded yet.

Senator Riegle. It's several billion dollars, not petty cash.

The Chairman. That's right.

Mr. Peterson. Could we submit for the record a case that's recently been decided in South Carolina, Wilson v. Allied Loans case?

The Chairman. Fine. I wish you would.

[The information follows:]
[From the Congressional Record, July 18, 1918]

HARRIET V. WILSON, PLAINTIFF,

v.

ALLIED LOANS, INC., DEFENDANT

[Civ. A. No. 77--808]

United States District Court, D. South Carolina, Columbia Division, March 14, 1978.

Suit was brought by borrower alleging that forms used by lender violated the federal Truth in Lending Act. On cross motions for summary judgment, the District Court, Chapman, J., held that: (1) lender, which actually acquired a security interest in any appliances or furniture acquired by the borrower within ten days of the loan date, violated the regulations by failing to disclose such interest; (2) since initial charge was not withheld from the amount financed, that initial charge was not required to be labeled as a prepaid finance charge,” and (3) disclosure of $159.63 figure on form labeled “Net cash from chart,” representing $167.24, the amount financed, less payments for credit insurance policies and eight cents for documentary stamps, was not confusing, misleading or inconsistent with disclosure requirements.

Judgment for plaintiff.

Marshall T. Walsh, Gaines & Walsh, Spartanburg, S.C., for defendant.

ORDER

Chapman, District Judge.

Since Congress, in all of its wisdom, has determined that federal district courts should preside over consumer complaints against finance companies relating to technicalities in language used in loan documents in which the lofty sum of $100 is at issue, this Court must now proceed to wade through the morass of technical regulations issued by the Federal Reserve Board in an attempt to reach the merits of this case.

Defendants made two installment loans to the plaintiff in which she borrowed $167.24 to be repaid in seven monthly payments of $28. Defendant secured this loan by taking a security interest in a range and set of bunk beds owned by plaintiff. In bringing this suit, plaintiff alleges that the forms used by defendant violated the Federal Truth in Lending Act, 15 U.S.C. § 1601 et seq., and that she is entitled under that Act to a judgment in the sum of double the amount of the finance charge or $100,1 whichever is greater, plus costs and attorney fees. 15 U.S.C. § 1640.

1 Plaintiff alleges that the disclosures made by the defendant on the loan document violated the Act in three ways. First, plaintiff alleges that the defendant failed to disclose that it was taking a security interest in after acquired consumer goods. She bases this claim on 15 U.S.C. § 1639(a) (8) which states that a creditor must disclose “a description of any security interest held or to be ... acquired by the creditor in connection with the extension of credit, and a clear identification of the property to which the security interest relates.”

Pursuant to 15 U.S.C. § 1604, the Federal Reserve Board promulgated the following regulations governing disclosure of security interests:

“12 C.F.R. § 226.8(b) (5)—In any transaction subject to this section, the following items, as applicable, shall be disclosed: (5) A description or identification of the type of any security interest ... acquired by the creditor in connection with the extension of credit, and a clear identification of the property to which the security interest relates. ... If after-acquired property will be subject to the security interest ... this fact shall be clearly set forth in conjunction with the description or identification of the type of security interest ... acquired.”

“12 C.F.R. § 226.8(a)—All of the disclosures shall be made together on either (1) the note . . . on the same side of the page [as the creditors] signature; or (2) one side of a separate statement which identifies the transactions.”

In this case, all information relating to each loan is contained on a single document. This document contains the full text of the note and the full disclosure of the loan terms on the front side. The text of the security agreement starts on the bottom of the front page and continues on the back. The document clearly discloses on the front page, in accordance with the statutes and regulations,
that a security interest is acquired in certain property identified as a range and a set of bunk beds. The alleged defect in the form is the fact that terms on the reverse side of the form extend the security interest to "all other goods of the same class now or hereafter acquired." Defendant argues in opposition to plaintiff's motion for summary judgment that no interest was acquired in after-acquired property because South Carolina law severely limits the effect of after-acquired property clauses with respect to consumer goods. S.C.Code Ann. § 36-9-204 (4) (b) (1976) provides:

"No security interest attaches under an after-acquired property clause to consumer goods other than accessions when given as additional security unless the debtor acquires rights in them within ten days after the secured party gives value."

Defendant's argument would be correct but for the 10 day provision. If state law had totally invalidated after-acquired interests in consumer goods, the language on defendant's form would have had no effect and no disclosure of a security interest in after-acquired property would have been necessary because no such interest would have been "acquired." Unfortunately for the defendant, since it actually acquired a security interest in any appliances or furniture acquired by plaintiff within ten days of the loan date, it violated the regulations by failing to disclose this interest. See Eckenrode v. Household Fin. Corp. of South Dover, 422 F. Supp. 1327 (D. Del. 1976). Since this violation is apparent from the face of the loan document, there is no factual issue and plaintiff is entitled to a summary judgment as to this claim.

Despite the fact that this Court feels compelled by the statutes and regulations to award the plaintiff the penalty established by the Truth in Lending Act, this result is absurd in light of the realities of this case. This barratrous legislation transforms loan documents into contest puzzles in which prizes are awarded to those who can uncover the technical defects. Unfortunately, these prizes are not paid by the sponsor of the contest, the government, but by finance companies who attempt to make a fair profit by leasing money while at the same time trying to insure that the loans will be repaid. They must necessarily use form documents which are sufficiently flexible to cover a wide variety of situations presented by both consumer and commercial loans. A penalty is imposed on the defendant in this case even though it has acted in good faith and despite the fact that plaintiff has sustained no damages. The violation in this case results from a minor technicality which arises from the operation of the 10 day rule relating to after-acquired security interests in consumer goods. The 10 day interest acquired was surely unwanted by the defendant, unimportant to the plaintiff, and unexpected by both parties. It gave no meaningful security to the defendant and its full disclosure to the plaintiff would undoubtedly have had no effect on plaintiff's decision to obtain the loan from the defendant.

[2] Plaintiff's second complaint about defendant's form is that an initial charge was withheld from the proceeds of the credit extended but was not labeled with the term "prepaid finance charge" as required by the regulations. The general disclosure requirements are set forth in 15 U.S.C. § 1639 and the relevant requirements and defendant's compliance with them follow:

(a) Any creditor making a consumer loan or otherwise extending consumer credit in a transaction shall disclose each of the following items, to the extent applicable:

(1) The amount of credit of which the obligor will have the actual use, or which is or will be paid to him or for his account. [Defendant disclosed this amount to be $154.63.]

(2) All charges, individually itemized, which are included in the amount of credit extended but which are not part of the finance charge. [Defendant disclosed itemized charges made for various types of credit insurance and documentary stamps which totaled $7.61.]

(3) The total amount to be financed (the sum of the amounts referred to in paragraph (1) plus the amounts referred to in paragraph (2)). [Defendant stated that the amount financed was $167.24.]

(4) The amount of the finance charge. [The finance charge was stated to be $28.76.]

The manner and specificity of the disclosures required by § 1639 are outlined in 12 C.F.R. § 226.8. After a circuitous jumping between paragraphs and subpara-

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* So much information is required to be printed on the face of the instrument that notes will soon be printed and rolled up as a Roman scroll.
graphs this regulation eventually establishes a requirement that any amount withheld by the creditor from the “credit extended” be labeled with the term “prepaid finance charge.” The clarity of the explanation of this requirement is apparent without a need for comment from the following quotations from § 226.8:

“(c) In the case of a credit sale, in addition to the items required to be disclosed under paragraph (b) of this section, the following items, as applicable, shall be disclosed:

“(6) Any amounts required to be deducted under paragraph (e) of this section using, as applicable, the terms ‘prepaid finance charge’ and ‘required deposit balance’ and, if both are applicable, the total of such items using the term ‘total prepaid finance charge and required deposit balance.’

(d) In the case of a loan or extension of credit which is not a credit sale, in addition to the items required to be disclosed under paragraph (b) of this section, the following items, as applicable, shall be disclosed:

“(1) The amount of credit, excluding items set forth in paragraph (e) of this section, which will be paid to the customer or for his account or to another person on his behalf, including all charges, individually itemized, which are included in the amount of credit extended but which are not part of the finance charge, using the term ‘amount financed.’

“(2) Any amount referred to in paragraph (e) of this section required to be excluded from the amount in subparagraph (1) of this paragraph, using, as applicable, the terms ‘prepaid finance charge’ and ‘required deposit balance,’ and, if both are applicable, the total of such items using the term, ‘total prepaid finance charge and required deposit balance.’

(e) The following amounts shall be disclosed and deducted in a credit sale in accordance with paragraph (c) (6) of this section, and in other extensions of credit shall be excluded from the amount disclosed under paragraph (d) (1) of this section, and shall be disclosed in accordance with paragraph (d) (2) of this section:

“(1) Any finance charge paid separately, in cash or otherwise, directly or indirectly to the creditor or with the creditor’s knowledge to another person, or withheld by the creditor from the proceeds of the credit extended.”

As if this explanation of the “prepaid finance charge” requirement were not confusing enough, the Federal Reserve Board made matters worse by issuing the following “interpretation” of this requirement codified as 12 C.F.R. § 226.819:

“(a) Section 226.8(c) (6), 226.8(d) (2) and 226.8(e) (1) require that certain finance charges be disclosed as “prepaid finance charges.” They also require that such prepaid finance charges be excluded or deducted from the credit extended in arising at the “amount financed.” The question arises whether add-on, discount or other precomputed finance charges which are reflected in the face amount of the debt instrument as part of the customer’s obligation, but which are excluded from the “amount financed,” must be labeled as “prepaid” finance charges.

“(b) The concept of prepaid finance charges was adopted to insure that the “amount financed” reflected only that credit of which the customer had the actual use. Precomputed finance charges which are included in the face amount of the obligation are not the type contemplated by the “prepaid” finance charge disclosure concept. Although such precomputed finance charges are not to be included in the “amount financed,” they need not be regarded as finance charges “paid separately” or “withheld by the creditor from the proceeds of the credit extended” within the meaning of § 226.8(e) to require labeling “prepaid” under §§ 226.8(c) (6) and 226.8(d) (2). They are “finance charges,” of course, to be disclosed under §§ 226.8(c) (8) and 226.8(d) (3).”

This interpretation clarifies the concept of prepaid finance charges like mud clarifies water. The regulation and interpretation repeatedly use the phrase “credit extended” as a starting point for determining whether a charge is a “precomputed finance charge” or a “prepaid finance charge.” The term “credit extended,” however, is never defined by the regulations. Only the terms “credit” is defined as meaning “the right granted by a creditor to a customer to defer payment of debt, incur debt and defer its payment, or purchase property or services and defer payment therefor.” 12 C.F.R. § 226.2 (1). How is the lender to know whether a part of the finance charge is withheld from the “proceeds of the credit extended” unless he knows what the term “credit extended” means? In the Instant

8 Anyone capable of deciphering 12 C.F.R. 226.8 and its “Interpretation” should be working as a cryptographer at the Pentagon and not for a bank or loan company.
case, if the credit extended is $196.00 (the total of the payments), then the $10.03 initial charge is withheld from the proceeds of the credit extended and it should have been labeled as a “prepaid finance charge.” If, on the other hand, the credit extended is $167.24 (the amount financed), then the $10.03 initial charge was not withheld from the proceeds of the credit extended and no “prepaid finance charge” label was required. Since no definition of “credit extended” is contained in the regulations, this Court defines the terms as it relates to this case to be synonymous with “amount financed.” Accordingly, since the initial charge was not withheld from the amount financed, that initial charge was not required to be labeled as a “prepaid finance charge.” Defendant, therefore, is entitled to a summary judgment as to this claim.

[3] Plaintiff’s third complaint is that the loan documents contained “information which is confusing, misleading and inconsistent with the Disclosure requirements of 12 C.F.R. § 226.6(c).” That section of the regulations provides that any additional information disclosed by the lender “[not] be stated, utilized, or placed so as to mislead or confuse the customer....” Plaintiff contends that this regulation was violated by the disclosure of the $159.63 figure labeled on the form as “Net cash from chart.” Plaintiff complains that the form gives “no explanation as to what these figures... represent nor is it indicated as to how this might be calculated.” The Court does not understand why plaintiff is confused by the $159.63 figure. The form clearly shows that the amount financed is $167.24. Plaintiff could have accepted that amount in cash; however, she elected to purchase various credit insurance policies. These policies and the eight cents deducted for documentary stamps totaled $7.61 which, when deducted from the amount financed of $167.24, equals $159.63. It is quite clear that this figure results from the deduction of the insurance and stamps from the amount financed. Furthermore, there is nothing confusing or misleading about the label “net cash from chart.” The form contains a chart showing, inter alia, the amount financed and the various insurance charges and the $159.63 net cash figure is clearly obtained from the figures on this “chart.” There is no merit to plaintiff’s complaint about this figure and the defendant is, accordingly, granted summary judgment on this issue.

It is, therefore, ordered, in accordance with the foregoing discussion, that judgment be entered in favor of the plaintiff in the amount of 100 plus costs of this action plus a reasonable attorney fee of $150.00.

And it is so ordered.

The Chairperson. Mr. Bolger, can you explain the IBAA affiliate membership proposal for us? Please indicate what’s similar to current proposals either before this committee or the House Banking Committee?

Mr. Bolger. Well, it would not require a stock ownership. It would give them access to the window. They would be required to pay for pricing as comparable to members but it would reduce somewhat the cost of membership. I think that the small bank might——

The Chairperson. I can’t see any difference in the way you describe it and the Fed proposal.

Mr. Bolger. Well, it’s voluntary.

The Chairperson. Very small banks would still be voluntary. With the small banks it would still be voluntary both ways.

Mr. Bolger. Yes; it would still be voluntary.

The Chairperson. Mr. Perkins, interest payments on demand deposits is prohibited by law and yet it’s well known that most banks allow their correspondent bank and corporate customers implicit interest on their demand deposits through mechanisms such as an earning credit or reduction in charge for services. Are these practices widespread and do you think that they are in violation of the prohibition against interest payments on demand deposits?

Mr. Perkins. They are widespread. It’s extremely well known and I really have never heard the question raised as to whether they are a violation of the law. I don’t think they are. The prices are explicit.
The earnings credit is explicit and when you price in the competitive world you’re pricing two sides of the cost.

The Chairman. Why isn’t that a violation in view of the fact that the law prohibits interest on demand deposits, and you say this is a widespread practice, this earning credit or reduction in charge for services—why isn’t that the same thing?

Mr. Perkins. I can’t imagine, except for a token balance to take advantage of the settlement system, why anybody would keep demand deposits in the bank if they couldn’t get any services for them.

The Chairman. I’m not challenging anybody’s integrity on this and I’m sure it’s legal, but I’m just wondering why this isn’t the same kind of thing.

Mr. Haywood. Mr. Chairman, may I suggest the answer may be in the wording of the Federal Reserve regulations governing payment of interest. That is, the law is very sweeping on this. It says payment of interest in any form whatsoever.

The Chairman. Right.

Mr. Haywood. It’s kind of curious how NOW accounts got into the picture with that kind of sweeping language in the Banking Act of 1933, but I believe that the Federal Reserve—that question has come up again and again over the years in various ways and I don’t have the facts right here, but I think if we looked at the Federal Reserve regulation on this we would find the answer there, that that credit through services is exempted.

The Chairman. Will you give us what you can for the record on that?

Mr. Haywood. Yes, sir. We will try to submit whatever we can on that.

[The American Bankers Association submitted what follows for the record. It is a quotation from the Interpretation of the Board of Governors of the Federal Reserve Systems:]

**SECTION 3175: ANALYSIS OF INDIVIDUAL ACCOUNTS**

A member bank recently requested the Board of Governors of the Federal Reserve System to consider whether the bank’s practice of analyzing individual accounts constitutes a “payment of interest” on demand deposits.

It appeared that the bank, in analyzing the accounts of depositors, uses a form known as “Monthly Account Analysis.” Use of the form involves the assessment against the account of theoretical costs for certain services performed in connection with the account as follows: Checks paid at five cents each, transit items at three cents each, clearinghouse items at one cent each, deposits at five cents each, list checks at three cents each, return items at ten cents each, and overdrafts at fifty cents each. The total of these charges is designated in the analysis as “Account Maintenance On Month” and to this total there is added 15 per cent. At the same time, the theoretical earning value of the account for the month is estimated by deducting from the average daily collected balance an amount equal to the 18 per cent required reserves and treating the so-called “Net Earning Balance” as though the bank had it invested at a rate of 1 per cent a year. If the cost of services, estimated in the above manner, exceeds the theoretical earnings on the account, the difference is set up as “Cost of Services in Excess of Earnings.” Apparently, the customer may be charged this amount for the services rendered by the bank. It is assumed, however, that in no case, as a result of the analysis, is any payment made to the customer or any credit given which increases the amount of his deposit balance.

The question raised by the correspondence involves the basic distinction between payments of “compensation for the use of funds” and charges made for keeping balances and performing other services for a customer. There is no Federal law or regulation which prohibits a bank from imposing so-called “serv-
ice charges" against a depositor—nor for that matter which requires it to receive deposits at all. Its relations with a customer and the service charges which may be imposed are matters of contract between the bank and the customer.

It is not unusual for the management of a bank to formulate some method of internal accounting designed to enable the management to analyze individual deposit accounts and determine the terms and conditions under which it will keep and service such accounts for depositors. It is common for a bank using an account analysis also to use as one of the factors in making the analysis its estimate of the return it can obtain by investing the funds which the customer has deposited with it. Likewise, it is common for such a bank to include in its analysis estimated factors of cost in servicing the account. In some cases the result is that the customer is charged by the bank for keeping and servicing the account. But the Board does not understand that in any case is a payment made to or for the account of the customer as "compensation for the use of funds." As the Board understands the facts, no payments are made at all. The analysis is simply an internal arrangement to enable the bank to determine whether it should make a charge. Under these circumstances, the Board was of the opinion that, under the facts of the specific case, the use of the "Monthly Account Analysis" is not a "payment of interest" and, accordingly, does not violate section 19 of the Federal Reserve Act or the provisions of the Board's Regulation Q.

Mr. Bolger. Mr. Chairman, commercial banks who provide services to our commercial customers provide more services based on their deposit. It's really not much different than the service the correspondent banks provide a bank.

The Chairman. Well, that's a good point. Again, you're indicating the great flexibility that the banks and the regulators have been able to foresee in that law. It prohibits interest on demand deposits, but in effect a kind of interest is paid.

Mr. Perkins, you said that the Federal Reserve should not charge less than the private sector for similar services. What if Federal Reserve costs are less than the private sector's?

Mr. Perkins. By that statement we meant the costs should be fully costed and have all of the cost in it including the cost of float.

The Chairman. You wouldn't object if they're lower if their costs were lower?

Mr. Perkins. No, sir. As far as being lower, if they are real, I think that the private banking system and those of us who provide many of these services can compete with them if the competition is fair and based on the same ground rules as far as the pricing goes.

The Chairman. Mr. Bolger, you said the charges for Federal Reserve services could create problems for small banks. We have been told that not many small banks use Federal Reserve services. If that's true, what problem do you see with the pricing of Federal Reserve services?

Mr. Bolger. Well, I think that that's if we do come to pricing of services. I think distances—it's going to be rather difficult to fix a price for services at a bank in Chicago, for instance, that's blocked from the Fed, delivering currency or coin to somebody out in the country. I think that could create a real problem to the dual banking system.

Mr. Perkins. Our principal concern with pricing is that it be based on fair and realistic prices and not some kind of marginal pricing or something. There are lots of ways to price. To say the price is way down here when the real price in the real world is somewhere up here is wrong—and it's a very complicated subject and our aim is that it be done fairly and be fully understood when it's done. Many
of us know by experience it's a very difficult subject. It takes a lot of work, a lot of experience, a lot of adjusting, constant work all the time.

The Chairman. Mr. Perkins, you favor pricing the Federal Reserve services. As you indicated, it would be a difficult task to set prices. How do you propose to do it?

Mr. Perkins. Well, I would think the prices would be set in the same way that any of us in the business set prices. We try to look at the whole question of what it costs us to do the services, what the competitive market prices are.

The Chairman. Let me give you an example of what my problem is. You include in your list of items to be included in pricing the cost of float.

Mr. Perkins. Sure.

The Chairman. Can you explain that cost to me and why and how the Federal Reserve should charge for float?

Mr. Perkins. Well, if we’re going to have competition in the market, with both the Federal Reserve and major suppliers in the banking industry supplying the same services, the banking industry pays the cost of float. In other words, it’s a question of when money is collected and when it isn’t and when we compute what balances earn in terms of what they are worth. If you have a $100 balance with us we don’t credit you for earnings of $100. Credit is given for earnings on $100 less the required reserves and then of that balance, only the money that is collected. You may have a nominal balance of $100, but you may have checks in process that haven’t cleared yet, so the actual investable balance may be only $50. So you have to allow for the cost of uncollected funds and the cost of reserve requirements in seeing what you can earn on the money you have on deposit, which is part of your price.

The Chairman. Thank you very much. That’s a helpful answer.

Mr. Haywood. I have one thing. The American Bankers Association has put out a request for proposal to leading accounting firms and consulting firms and an outline of that is attached to our testimony, but we have received proposals. We will be reviewing four firms on Thursday to make an award for a very, very detailed study on this very question of pricing and the possible implication for our system.

The Chairman. I'd appreciate that very much. That's a great contribution to our understanding too. We would be looking forward to getting that study.

Mr. Perkins. It will be a very, very large study.

The Chairman. I want to thank you gentlemen very, very much for your testimony. It’s been most helpful and we very much appreciate it.

Our final panel consists of Mr. John L. Donovan, vice president and treasurer, Casco Bank & Trust Co., Portland, Maine; L. Manley Preston, president, First National Bank of Canton, Canton, Pa.; and Jeremiah P. Shea, president and chief executive officer, Bank of Delaware, Wilmington, Del.

Gentlemen, we appreciate your patience. We would appreciate it also if you could limit your oral remarks to 10 minutes or less and the balance of your remarks will be put in the record. I'm going to have
to leave shortly. Senator Don Riegle will take over the chair in a few
minutes, but proceed now. Mr. Donovan.

STATEMENT OF JOHN L. DONOVAN, VICE PRESIDENT AND TREASU­
RER, CASCO BANK AND TRUST COMPANY, PORTLAND, MAINE

Mr. DONOVAN. Mr. Chairman, members of the committee, my name
is John L. Donovan. I am vice president and treasurer of Casco Bank &
Trust Co., Portland, Maine. It is indeed a pleasure to have this
opportunity to share with you some of my views on S. 3304 and the
companion bills which are being heard in the House.

By way of background, Casco Bank & Trust Co. was founded in
1933. Throughout all of its existence, it has been a State nonmember
insured bank. At June 30, 1978, we had total deposits of $318 million.
Transaction accounts as defined totaled $142 million of which demand
deposits were $102 million and NOW accounts were $40 million, retail
time and savings, $124 million and large C/D's were $52 million. We
operate 36 branches throughout the southern and western part of
Maine.

In regards to this legislation, I would like to concisely address four
major points: (1) the requirement that these reserves be kept at the
Federal Reserve Bank or a member bank; (2) the requirement for
uniform reserves for all depository institutions; (3) the payment of
interest on reserves held at Federal Reserve Banks; and (4) the im­
position of charges for certain services provided by the Federal Re­
serve Banks.

Based upon published reports of testimony by other Federal regu­
lators, trade groups and state regulators, my concerns with these four
points should not be too surprising. However, I hope to present per­
suasive arguments that in fact certain of these proposals will have a
permanent and not always beneficial effect to banks like Casco. I be­
lieve that the bill's inequities which are discussed below, seriously de­
tract from the desirability for its passage in its present form.

(1) The requirement that reserves be kept at Federal Reserve Banks
or a member bank

In section 105, the bill requires that all depository institutions,
which term includes all commercial banks whether member or non­
member, all savings banks, savings and loans and credit unions, main­
tain their reserves on transaction accounts in one of four methods.
These are vault cash, balances at a Federal Reserve bank, balances at
a Federal Home Loan bank or balances at a member bank. This last
method, "balances at a member bank" will cause irreparable harm to
the ability of Casco and all nonmember banks to compete for business
on an equal basis with member banks. It is discrimintory, anticompeti­
tive and unfair.

Presently, nonmember banks can equally compete for the accounts
of all types of depository institutions, with the exception of member
banks. These are usually working accounts, like most other business
accounts. In many cases, where required, they also double as reserve
balances for the depository.
Now this bill would prohibit these accounts from being used to satisfy the reserve requirements on transaction accounts. In this day of high interest rates, the Treasurer cannot afford the luxury of idle balances. In fact, isn’t that what led to all this discussion about providing member banks with a method of earning interest on sterilized reserve balances.

At Casco, for example, we have over 110 accounts from financial institutions with average balances in excess of $8.5 million. In most cases, these are both reserves and working balances. We stand to lose those balances if they cannot be counted as reserves. At our current earnings rate of 9.83 percent we will lose over $800,000 in pretax income when those balances are pulled. That is $400,000 after taxes or almost 20 percent of 1977 earnings.

If section 105 is enacted in its present format, depository institutions will be forced to sever longstanding and mutually beneficial account relationships. Casco and all nonmember commercial banks will be put in the posture of being a legislatively disadvantaged competitor. This can easily be corrected by amending the section and inserting a comma and the words “nonmember bank or trust company” after the words “member bank” throughout section 105(a) (2).

(2) The provision for uniform reserves on transaction balances

Like most commentators, I object to the concept of a uniform reserve requirement on transaction accounts for all depository institutions. Interestingly in Chairman Miller’s letter and supporting documents, the only justification for a “universal” reserve requirement is that it “would place all depository institutions on a more nearly equal competitive basis.” After my earlier remarks I respectfully disagree. Without commenting on the logic of a proposal for “universal reserves” on deposits which excludes time and savings deposits, I suggest to this committee and the Congress that the most effective method of placing all depository institutions on a more equal competitive basis would be to eliminate the interest rate differential. However, that is not today’s issue.

It appears to me that the need for uniform reserve requirements is needed only to simplify the District Reserve Banks’ mathematical computations. If the bill is amended both to permit interest pass-through and remove its anticompetitive sections, then I, for one, will not object to uniform reserves.

(3) The payment of interest on reserves held at the Federal Reserve Banks

I can appreciate the desirability of permitting the payment of interest on reserve balances. While it would be inappropriate to force membership on a state-chartered bank in The Federal Reserve System, it is clearly desirable that the number of such banks which become or remain a Fed member be maximized to permit the most effective implementation of monetary policy.

This bank, from its inception in 1933, has never been a member of the Federal Reserve System. However, there would be a very strong
motivation for us to do so if interest were paid on reserve balances. I 
believe similar motivations would apply to many other banks either 
to join, rejoin, or remain a member of the System, if the legislation 
were approved.

It is necessary that this section be adopted. In my opinion, it will 
go a long way towards solving the membership problem. However, 
before the issue is permanently lost in campaign rhetoric, and dem-
agoguery over Treasury rip-offs, I suggest that this committee give 
favorable consideration to permit the interest payment to be tied to 
market rate and without limitation on amounts of individual pay-
ments. Any other method would be artificial and result in someone 
subsidizing somebody.

(4) The imposition of charges for certain services provided by Federal 
Reserve Banks

I strongly support the concept of explicit pricing of Federal Reserve 
services. I will ignore the philosophical debate as to whether or not the 
Fed should be involved in the payments mechanism which enables 
private citizens, businesses, and local governments, to make payments 
for goods and services. The fact is that it is involved. The present 
challenge is to maximize the opportunity to mold that involvement 
into providing public benefits.

At the present, most district Federal Reserve banks refuse access 
to nonmembers on the theory that the noninterest-bearing reserves of 
the members are providing payments for the services that the Fed 
provides. However, if it was forced to explicitly price these services 
on a fee basis without differentiating between member bank and non-
member status, then access and use of these services would be based on 
a willingness and ability to pay for the service and a desire for those 
services. This voluntary access should commence on the effective date 
of the pricing and not delayed as the Fed proposes.

In the documentation accompanying its legislative proposal, the 
Fed outlined certain principles that it would use as guidelines for 
establishing prices. To those I would add the ones outlined in S. 2595— 
that is based upon fully allocated current costs, both direct and in-
direct, provisions for taxes and capital and based on known volumes.

To summarize, I feel that S. 3304 has the potential to resolve some 
of the real banking problems of today. However, I caution this com-
mittee to examine its provisions and not permit a Fed drafted bill from 
becoming anticompetitive and discriminatory to nonmember de-
pository institutions.

Thank you for inviting me and I will be happy to respond 
to questions.

Senator RIEGLE. Thank you very much.

I thing we’ll listen to all three presentations before getting into 
questions. So, Mr. Preston, do you want to proceed.

[Complete statement follows:]
INTRODUCTION

I appreciate the opportunity to give you my views on the problems of retaining a dual system of banking in the United States and on Senate Bill 3304. I represent only myself, my bank, and its customers, but I believe that other small Federal Reserve member bankers are in substantial agreement with me on most points.

This legislation will, very likely, be seen as the "last hope" of many small national and Federal Reserve member bankers. If useful action is not taken, the deterioration in the nationwide network of banks, large and small, that are directly supervised and regulated by the Federal Government and its agencies will continue. I feel that time is running out and that something should be done quickly.

I know that you need comments on the legislation being considered and I will give them to you; but feel that there may have been too little emphasis on the non-monetary effects of the departure of small banks from the Federal Reserve System.

PROBLEM

Small banks are leaving the Federal Reserve System because of an unbalanced nationwide system of reserve requirements. There may be philosophical reasons also but no banker I have talked to left the Fed
for any reason other than the opportunity to move into a system that had lower or more liberal reserve requirements. This attrition of banks is well documented.

I am sure that you have heard or will hear testimony on the problems that this gives the Fed as they set and carry out monetary policy. I am not so sure that much attention has been given to non-monetary considerations.

When the National Banking System was established by Congress, a nationwide network of banks, large and small, was created. These banks were regulated, supervised and influenced by federal legislation.

In return, these banks have served the Federal Government as a window into the communities they serve. The national interaction between bankers, examiners, and legislators has been valuable to the whole nation.

Except for the inequities in reserve requirements I like being a national banker. I believe this nationwide system of banks, immediately responsive to federal legislation, has served its customers and the country well.

I believe that the help and regulation of the office of the Comptroller of the Currency, especially as demonstrated in the last few years, will create an exceptional network of sound, well managed banks, that will help us maintain a vigorous, efficient economy.
Back to the problem. As a national bank we must belong to the Fed. Because of this we must keep a non interest bearing reserve balance at a Federal Reserve Bank. We're a small bank. Our reserve requirement is about $500,000. A correspondent bank would probably be delighted to give us the same services that the Fed offers for a balance of $150,000. The $350,000 difference less necessary vault cash, could be easily invested to earn about $14,000 a year.

State banks that are non-members also have reserve requirements but as I'm sure you know, these are often lower and can usually be placed partly with correspondent banks of their choice and partly into interest bearing securities. I also understand that in some states, the enforcement of these requirements is not stringent and that penalties are often light or non existent.

Our bank is bearing a burden that is not being born by state banks and others that are our competitors. When I say our bank; I mean our customers, our employees, and our shareholders. I say this because any increased cost eventually hits each member of each of these groups.

THIS DOESN'T SEEM QUITE FAIR

This doesn't seem quite fair. The Federal Reserve System is the only organization in the United States that has a primary responsibility to study and influence the economy so that individuals, businesses, labor groups, farmers, consumers, foreign countries and our government will benefit.

All expenses incurred in this effort are paid from revenues generated
by the operation of the Federal Reserve Banks.

Any profits generated go to the United States Treasury.

Income from other than earnings on securities is negligible.

National banks and Federal Reserve member banks are the only organizations that are required to keep sterile, non-earning (except for services) reserves at the Federal Reserve Banks.

THEREFORE, only national banks and Federal Reserve member banks directly support the nation's monetary regulatory system---to the benefit of all others including their competitors. Additionally, the excess funds generated by the use of their reserves is used to reduce the tax load of the rest of the nation.

This doesn't seem quite fair.

If this isn't fair; if national banks and their customers are bearing an extra burden that helps competing institutions directly and indirectly--why don't they do something about it? They are. They're leaving the Fed.

Why does a bank stay? High hopes and inertia mostly (except for large correspondent banks who will stay as long as banks are required to keep correspondent balances with a Fed member).
As a national banker I've learned the national laws. The regulations and the examination system are familiar to me. To change means a new charter, a new name, new forms, new signs, explaining to customers, learning new ways. Small bankers don't need this kind of work. They have enough as it is, and lack the time and help to work on it. Still--they are leaving.

I understand the problems the Congress has in bringing an equitable solution to the problem. I would urge you to listen to the reasons why state bankers and others do not want a uniform reserve requirement. With a universal reserve requirement the problems they would have are the ones we have now. Can you blame us for leaving?

LEGISLATION UNDER CONSIDERATION

To move on to the legislation being considered. It's complicated, probably won't correct the problem, and still seems unfair; but it's a start.

Uniform Reserve Requirements

It is too bad that such a complex bill is necessary to solve such a simple problem. If all financial institutions were required to help in the nation's efforts to maintain good times by keeping reserves at a Federal Reserve Bank, the complications of pricing and paying interest on reserves would be unnecessary and the Treasury would receive increased revenue from the Federal Reserve Banks! This would be coming out of the earnings of those financial institutions that now get a free ride.

However that may be; any reduction in reserves will help and the addition of other institutions even if limited to demand deposits and
transaction accounts, will tend to ease the inequities we now bear. I can see that there will be pressure from non member institutions now and later, to eliminate or water down this section.

Payment of Interest on Reserves

Paying interest on reserves is also an effective and simple way to solve the problem; perhaps the simplest; but the reported amounts proposed seem inadequate in today’s market, especially when coupled with charges on Fed service.

I feel that the exodus of small banks from the Fed would cease and some might even return if interest paid on reserve accounts was at or near market rates.

I understand the concern of Congress that payment of interest would reduce the amount the Fed turns over to the Treasury each year out of their earnings. I appreciate the concern for the taxpayer who would have to make this up. However; disregarding services, the amount paid to member banks would be just about the amount that member banks are now subsidizing the monetary control system of the country.

If the amount of this present subsidy was paid to member banks as interest, it would eventually be distributed to stockholders in increased earnings, to their employees in increased salaries, or to the customers in less expensive or improved service. These are taxpayers too—in effect now subsidizing their neighbors.

Charges for Service

Another part of the proposed bill calls for charges for service and serving non-members. Why not, if it’s a fair charge for services rendered and other factors are equitable?
But—I see no reason why my bank should pay penalties of membership and also pay for service at the same rates as non-members.

There is no question that the services provided by the Fed to member banks are valuable and well handled. The problem arises when required reserves that "pay" for these services are seen to be worth more in the market place and in correspondent banks.

Another factor related to service that encourages inefficiency on our part and in the operation of Federal Reserve Banks: When you don't have to pay extra for something that is offered, you may eat it, drink it or use it even if you don't really need it. Some of the Fed services (that are now the only non-legislative tools that can entice membership) may be used simply because they are there, and have been more than paid for. A realistic service charge on services offered would probably weed out non-economic uses of Federal Reserve facilities and staff.

I have no objection to paying for service if everything else is equal and I have a choice. As it is now, we have no real choice and are indirectly, through balances, paying far more than the going rate.

I can see pressure coming from correspondent banks and taxpayer groups to keep these charges high.

ALTERNATIVES

If a bill giving equity to member banks is passed, the Fed's problem of attrition will be solved. Anything less will allow the slow death of national banking as we know it, and the Federal Reserve System will be made
up of a few large banks and some weak, small ones that don't have the
gumption to leave or the knowledge that they are being taken advantage of.

CONCLUSION

The legislation being studied may be the "last hope" of small national
and member banks who want to remain in their system--we need action.

The bill takes a complex, still inequitable approach that is apparently
made necessary by the reluctance of non-member institutions to shoulder an
additional part of the nation's monetary regulation load.

If the bill passes as proposed it may not stop membership attrition.

To sum up my specific thoughts on Senate Bill 3304: Reserve require­
ments will still be inequitable and member banks must subsidize their
competitors and others. Proposed payment of interest on reserves is not
efficient enough to balance the remaining unfairness of preferential reserve require­
ments. Charging for services would be a good idea except for the other
legislated inequities between users.

I am concerned that after the bill is passed there will be inexorable
pressure to reduce the interest paid on reserves to "protect the taxpayer", and to increase the price of services to prevent "unfair competition" with
private enterprise. This, combined with unequal reserve requirements,
makes the prospect for retaining Federal Reserve member banks dim, for
regaining them dismal, and for running one difficult.
Even so it's a start. I appreciate your efforts and hope you can find a way to improve the bill now or later in a way that will restore equity and help retain a strong, effective, nationally responsive central banking system.

Thank you for the opportunity to express the views of a rural banker on a very important problem.
Senator RIEGLE. Well, thank you. Let me just ask one question before we go on and then we’ll take our last witness here.

That is, how actively do you and others in the bank talk about the decision as to stay in for a while longer or do you finally decide that it’s time to leave? How much is that really an active topic of conversation, a pending decision that’s in front of you?

Mr. PRESTON. In our board of directors meeting we have one director that probably says, “Hey, how about being a State bank, what would that do for our profits,” probably about once every 6 weeks. It’s the same fellow and the others all nod.

Senator RIEGLE. But yet the step isn’t taken, so something—

Mr. PRESTON. High hopes and inertia, I think, is the answer to that. So the rest of the members, while they listen to what he’s saying, they may be getting nudged his way, but they still aren’t to the point where they are willing to follow his suggestion. Is that the point?

Mr. PRESTON. I think they’re ready. If I would nod my head yes, they would say when can we start. I have enough to do without that.

Senator RIEGLE. So you’re sort of the one who could in a sense cause the board to make that decision?

Mr. PRESTON. Tomorrow morning.

Senator RIEGLE. And you’re close to the point of throwing in the towel but you’re not quite there yet?

Mr. PRESTON. High hopes and inertia. In our community they were all national banks. By our community, I mean our area. We have lost a few through mergers. We are about two national banks now instead of eight.

Senator RIEGLE. But you would like to remain a national bank?

Mr. PRESTON. I like the system. I understand it. I think it’s improving every day. The bank examination system especially will eventually, in my opinion, create a chain of well-managed banks. In this new system, the Comptroller of the Currency is emphasizing management, not Government control. I like that. I’d like to stay with it. State systems are fragmented probably. There are probably some great ones and there are probably some that aren’t so great. Also the continuity in the State—I have seen in our own State good years, mediocre years, bad years.

Senator RIEGLE. This is not exactly germane—that’s sort of a term of art around here—but how do you feel about Bill Miller? How do you think he’s getting along?

Mr. PRESTON. He’s getting some action. I like him. It’s been too much talk for the last 5 years.

Senator RIEGLE. So you feel pretty good about him so far?

Mr. PRESTON. So far.

Senator RIEGLE. Mr. Shea, why don’t we hear from you?
STATEMENT OF JEREMIAH P. SHEA, PRESIDENT AND CHIEF EXECUTIVE OFFICER, BANK OF DELAWARE, WILMINGTON, DEL.

Mr. Shea. Thank you, Senator.

My name is Jeremiah P. Shea. I’m president and chief executive officer of the Bank of Delaware, Wilmington, Del. I don’t intend to repeat the remarks submitted earlier but will briefly summarize and supplement those remarks.

Our bank is one of 17 commercial banks operating within the State of Delaware. Of these 17 banks, only 5 are member banks, and that by reason of their national charter. They are small banks representing only 2½ percent of the total banking resources within the State of Delaware.

Our State is perhaps unique in having such a small Federal Reserve presence. We are a publicly owned company, a local company with 5,700 stockholders, none of whom owns as much as 1 percent of our stock. There is no controlling stockholder interest. We are something over $600 million in total resources and we operate 30 branches around the State.

In 1972, as I outlined in my formal remarks, we gave up, and reluctantly I might add, a 54-year relationship with the Federal Reserve System. Our bank then, as it is now, was strongly oriented to the credit needs of our local community. Our loan-deposit ratio, as an indicator, has not been below 65 percent in my memory and usually in the 70-75 percent range, and currently it’s running about 70 percent with almost all lending being done to Delaware business.

We left the Federal Reserve System because of the cost of continued membership, because of the loss of lendable funds that this immobilization of reserves represented, and for competitive reasons as outlined in my prepared remarks, in a community with four strongly competitive banks, two of whom were members, two of whom were not.

The heavy demands of Federal Reserve membership siphoned funds that we could lend and it reduced bank earnings substantially. We experienced a 35-percent share of saving in the first year after our departure or about 10 percent of our 1972 earnings or in terms of dollars, about $450,000 saved after taxes.

As I understand Senate Bill 3304, it would essentially return us to our pre-1972 condition. It would substantially increase our costs. It would immobilize funds that we are now able to invest or otherwise use to pay for services. It would enhance the competitive advantage of noncommercial institutions over us and over other commercial banks in the area.

A minor point perhaps, but the 25 percent per year phase-in referred to with respect to the new reserve requirements is only a device that would delay the day of reckoning.
We don’t believe that uniform reserve requirements are necessary to achieve the Federal Reserve quest for greater monetary policy effectiveness. If the conditions of membership were more attractive, we think that the tide would turn as nonmembers and former members considered this situation, their cost-benefit ratio. If we are proven wrong in this theory, if this did not produce the desired results, then we would have to admit it and say that universal requirements would appear to be the next logical step.

A plan acceptable to us, if universal requirements came into effect, would allow vault cash to count as reserves, which it does now under both State and Federal rules, but it would also allow correspondent working balances to be counted as reserves which it does now under the State but not under the proposed Fed rules. It would substantially reduce both the range and the rate of reserve requirements. It would allow for the payment of interest at reasonable market rates on those reserves maintained in the Federal Reserve Bank of Philadelphia. It would require the Fed to charge explicit rates and prices for services rendered. It would make provision for inclusion in the total deposit base of those savings and time deposits not confined to commercial banks alone, but those in thrift institutions as well, referred to in the proposed legislation as transaction accounts.

It would allow—and here I’m digressing to Congressman Reuss’ proposal of last week—that the rediscount rate would continue its present function as a signal flag to the financial community.

Finally, we would strongly suggest separation of the consideration of interest on reserves from the pricing of services. The Fed, through S. 3304, is saying in effect that we will give you a dollar as long as we are legislatively authorized to take it back, and in fact must take it back because of Treasury financing requirements.

I agree with Mr. Perkins and others who have spoken here this morning that the tie-in of pricing and reserves along with Federal budget requirements is not or are not homogeneous considerations.

I would be pleased to answer any questions that you may have.

Senator Riegel. Thank you, Mr. Shea.

[Complete statement follows:]
STATEMENT OF JEREMIAH P. SHEA, PRESIDENT AND CHIEF EXECUTIVE OFFICER
BANK OF DELAWARE, WILMINGTON, DELAWARE

TO: SENATE COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS
THE HONORABLE WILLIAM PROXMIRE, CHAIRMAN
AUGUST 15, 1978

In October, 1972, after fifty-four years of membership in the Federal Reserve System, we reluctantly decided to withdraw and assume the status of a state, non-member bank.

In arriving at this decision, we reviewed the benefits, obligations and costs of membership in the Federal Reserve System. We also had to deal with the, perhaps, emotional aspects of a long-term relationship based on an endorsement of the idea—which we still promote—that a strong, independent central bank is essential to the functioning of government. Our Chairman is a former member of the Board of the Federal Reserve Bank of Philadelphia. I began my banking career as an employee of that same bank.

So, you see, we were the victims of conflicting emotions in 1972, when we decided that membership was a luxury we could no longer afford.

At that time, only 41% of all commercial banks were members of the System, but they represented 79% of all commercial bank deposits. In 1940, twenty-two years earlier, 46% of all banks were members, representing 89% of commercial bank deposits. Even then, the erosion of membership was evident.

Why, then, did we leave?

There were two primary reasons. First, we are one of four major banks in the Delaware community. Two were members, two were not. The non-members had a definite competitive advantage in that they could maintain fewer resources in cash/bank balances than Bank of Delaware or Wilmington Trust, the other member.

<table>
<thead>
<tr>
<th>Cash and Bank Balances as % of Total Assets</th>
<th>Delaware Trust</th>
<th>Farmers Bank</th>
<th>Bank of Delaware</th>
<th>Wilmington Trust</th>
</tr>
</thead>
<tbody>
<tr>
<td>1971</td>
<td>6.2</td>
<td>10.6</td>
<td>14.6</td>
<td>16.8</td>
</tr>
<tr>
<td>1970</td>
<td>6.9</td>
<td>10.2</td>
<td>16.8</td>
<td>18.3</td>
</tr>
<tr>
<td>1969</td>
<td>7.9</td>
<td>7.3</td>
<td>15.7</td>
<td>20.4</td>
</tr>
</tbody>
</table>

Second, as a non-member bank, we would have employed over $15 million more in earning assets, an increase of 5%. This difference is accounted for by the fact that as a state non-member bank, correspondent
bank balances and cash would qualify as legal reserves. Based on our average deposits for the first eight months of 1972, the entire (non-interest bearing) balance at the Fed could be converted to earning assets should we operate as a non-member bank. This statement is based on the then existing reserve requirements which are detailed below:

### COMPARATIVE RESERVE REQUIREMENTS
(October, 1972)

<table>
<thead>
<tr>
<th>Net Demand Deposits</th>
<th>F.R.B.</th>
<th>Delaware</th>
</tr>
</thead>
<tbody>
<tr>
<td>$ 0 - 2 million</td>
<td>8%</td>
<td>8%</td>
</tr>
<tr>
<td>2 - 10 million</td>
<td>10%</td>
<td>8%</td>
</tr>
<tr>
<td>10 - 100 million</td>
<td>12%</td>
<td>8%</td>
</tr>
<tr>
<td>100 - 400 million</td>
<td>13%</td>
<td>10%</td>
</tr>
<tr>
<td>Over 400 million</td>
<td>17%</td>
<td>10%</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Time Deposits</th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>0 - 5 million</td>
<td>3%</td>
<td>3%</td>
</tr>
<tr>
<td>Over 5 million</td>
<td>5%</td>
<td>3%</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Savings Deposits</th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>3%</td>
<td>3%</td>
</tr>
</tbody>
</table>

**Composition of Legal Reserves:**

- **Federal Reserve** - Vault cash and collected funds held in a deposit account of Federal Reserve Bank of Philadelphia. (Correspondent bank balances do not qualify.)
- **State of Delaware** - Vault cash and all bank balances, including correspondent bank balances and items in the process of collection.

**Applying the reserve requirements outlined above to our average demand and time deposits at that time, we made the following comparison:**

<table>
<thead>
<tr>
<th>Reserve Requirements</th>
<th>F. R. B.</th>
<th>Delaware</th>
</tr>
</thead>
<tbody>
<tr>
<td>Required on Demand Deposit</td>
<td>$16,639</td>
<td>$13,642</td>
</tr>
<tr>
<td>&quot; &quot; Time/Savings Deposits</td>
<td>$4,543</td>
<td>$3,993</td>
</tr>
<tr>
<td>Total Required Reserves</td>
<td>$21,182</td>
<td>$17,635</td>
</tr>
<tr>
<td>Less: Average Vault Cash</td>
<td>$4,375</td>
<td>$4,275</td>
</tr>
<tr>
<td>Net Balance Requirements</td>
<td>$16,803</td>
<td>$13,256</td>
</tr>
<tr>
<td>Due from Banks, etc.</td>
<td>--</td>
<td>13,256</td>
</tr>
<tr>
<td>Averages Held</td>
<td>16,803</td>
<td>19,520</td>
</tr>
<tr>
<td>Excess Reserve</td>
<td>-0-</td>
<td>$6,264</td>
</tr>
</tbody>
</table>
1) The comparison made in the foregoing is based on total deposits of $292.4 million (consisting of $159.3 million in demand deposits, and $133.1 million in savings and time deposits). These figures are typical of the second half of 1972.

2) As a non-member bank, we released the entire $16.8 million held at the Federal Reserve Bank of Philadelphia. Approximately $1.0 million of these funds were needed to compensate correspondent banks for added services, such as wire transfers, coin and currency shipments, and custody of bank-owned securities.

3) The remaining $15.8 million were employed in short-term securities, mostly as a pledge against uninvested trust funds. Earnings at a rate of 5.5% returned $869 thousand, worth 35¢ a share, after tax, in the first year after our departure.

4) Bank balances were $6.2 million in excess of required legal reserves for a non-member bank. When deposit growth absorbed this excess, the value was an additional $340 thousand, or 14¢ per share, after tax.

The statistical data reported above is based on our 1972 situation. Today, based on current non-member reserve requirements, we must reserve $22.5 million dollars against $162 million of demand deposits and $330 million of savings and time deposits. Our available reserve, by definition, includes $5.4 million of cash and $24.1 of correspondent balances. We could, if needed, also count our unpledged U.S. securities with a maturity of five years or less.

If Senate Bill 3304 is enacted, the cash and balances listed above would continue to be needed but we would immobilize an additional $10-12 million in deposits at the Federal Reserve Bank of Philadelphia. This figure is based on an assumed average reserve requirement of 8% on $162 million of demand deposits with some offset ($1-2 million) for correspondent balances no longer required.

We made the change to non-member status without any loss of liquidity and with an incremental improvement in the ratio of capital to assets (by reason of increased earnings). We actually improved the speed of check clearance, because our correspondents, using round-the-clock operations and direct sendings, had a faster availability schedule than the Federal Reserve System. Faster collection means savings (and lower risk of loss) to us and our depositors. Wire transfer services were conducted outside the Federal Reserve System through correspondent banks. With adequate balances at those banks (counted as reserves by Delaware law), we anticipated and experienced no deterioration in service.

Our greatest concern was the potential hazard posed by loss of access to the "discount window." This, despite the fact that we had only used the "window" nine times in ten years, for an average of four days each time, and then only because the "window" was cheaper than
other sources of funds. To substitute for the "window" we arranged substantial lines of credit with several correspondents, at rates below the discount rate, to be used for reserve purposes. In addition, we can still borrow from Fed at a rate 2% above the discount rate.

* * * * * * * * *

If we are able to operate effectively without a direct association with the Federal Reserve System, what should our position be on the questions of

a) uniform reserve requirements?
b) interest on reserves?
c) pricing for services?

I. Uniform Reserve Requirements

If we believe—and we do—that the Fed should have adequate control of monetary aggregates, we cannot dispute the concept of uniform reserve requirements. We would suggest, however, the following limitations:

a. Exclude, except in a nominal way, the smallest independent banks.
b. Include other financial institutions, savings banks, savings and loan associations and credit unions, whose deposits formerly constituted "M-3" but which now, by reason of checking accounts, NOW accounts and share drafts, are readily convertible to "M-1" deposits.
c. Substantially reduce the rates and ranges of required reserves, since a greater national deposit base would be included under any uniform reserve requirement.

These limitations would reduce the earnings impact on all affected institutions. It would eliminate certain competitive disadvantages and would meet the Fed's goal of controlling a greater percentage of the deposit base. All of these were identified as desirable goals by Congressman Reuss in his remarks before the House on July 17.

Interest on Reserves

Please recognize that we approach this subject lacking the scholarly historical perspective that you and your staff may share. Our limited knowledge of the Federal Reserve System does not identify bank reserves as an intended source of income to the Federal government. Under the present system, reserves of member banks are non-income producing assets. The income that results from their investment by the Federal Reserve System is, by and large, contributed to the U.S. Treasury. From our point of view, our assets are taken and invested and the income, after Fed's expenses, are passed to government and not back to the owners of the funds. In other words, the income from our sequestered assets represents a substantial hidden tax on the banking system.
Feeling as we do, we must identify interest on reserves as an overdue idea. Our difficulty lies in the relating of these payments to charges for service. These are two different subjects, from where we view it. Interest should be paid; it should be at a rate approaching or equaling the return that the depositing bank could have obtained through money market investment. Or, as an alternative, stockholders (members) of the Federal Reserve System could receive a fluctuating dividend calculated by formula and based on the earnings of the Federal Reserve Bank in their District. This, in itself, would be an incentive to membership.

Pricing for Services

The existence of Federal Reserve's nationwide operations network is of the utmost importance to the banking system. It should be maintained. Users of the network should expect to pay for it.

What price to charge? The answer to this can be found in the same considerations a profit-oriented institution would consider, i.e., direct costs, indirect costs and the cost of credit extended through Federal Reserve "float." The cost of services rendered to other agencies of government should be included in the formula, if they are not already.

The pricing system we would suggest would be analogous to the system we use in dealing with our corporate and commercial depositors. Under that method, an earnings credit on average deposits is calculated on the basis of a money market indicator. This number is used to calculate a theoretical earnings credit. The customer's use of services is charged against this credit on the basis of an explicit price schedule for each type and unit of service. If he is a heavy user of service, there will probably be a net charge that is billed or posted to his account. Light use of service usually results in a net earnings credit. This net credit is a consideration in the pricing of other bank services, such as use of our loan facilities, etc. Something along these lines might be the basis on which Fed can deal with members and non-member depositors.

To say that interest paid on reserves cannot exceed income collected for services places an artificial barrier on a system that a) must attract/retain members, b) must be competitive, c) must pay attention to its "bottom line" and d) must maintain a level of financial service to the nation.

The discount facility is the "emergency ward" of the banking system. It should be available to all, but not necessarily without preferences. Members, already accepting sub-normal returns on their deposited reserves, should continue to enjoy a rate differential at the "window." Further, anyone using the discount privilege must expect to supply whatever information the lender may reasonably require.

Competition lies at the base of most of the improvements made in the check-clearing system. Subsidized pricing by an agency as large as the Federal Reserve System would obviously endanger this multi-faceted structure and should, therefore, be avoided.

* * * * * * * * *
One of the House proposals would tie the discount rate to the yield on 90-day Treasury Bills. Within the industry, most bankers view the discount rate as a psychological weapon, infrequently considered except as a barometer of Federal Reserve attitude. To change its method of calibration would make it a mirror of the current market rather than a signal of Federal Reserve analysis. In other words, the change in the discount rate mechanism as proposed would rob the discount rate of its peculiar value.

Also, there should be a survey to see how many states have tied their usury rates to the discount rate. This change could create a great deal of turmoil for them.

It has been an honor for me to be able to present these observations and remarks to your Committee. It is a complex subject and there is no one correct answer. I hope our views will be of some help.
Senator RIEGLE. How much inflation are we seeing at the present time and over the last 2 or 3 years in terms of bank services to customers? In other words, as you price out different aspects of what you can do for somebody who banks with you, how much inflationary pressure are you experiencing and how much are you having to pass on to your customers? Any of you can respond to that if you wish.

Mr. SHEA. The inflationary pressure is there. Obviously, we are in a labor intensive industry that is trying to shift more toward a capital intensive industry in an effort to contain those costs. I couldn’t put a dollar figure on it because it’s not that clear-cut. Where heavy labor use is involved it’s substantial and where we have been able to automate we have been able to fairly well hold the line.

Senator RIEGLE. How do you pass on costs to customers? What’s the most direct way that you can push a cost increase that you’re experiencing on through to the user of your services?

Mr. SHEA. In the case of consumer depositors, checking accounts primarily. That’s done through either the establishment of a balance requirement or the charging of a monthly fee or the two in concert; that if a certain balance is not maintained that there is a monthly fee for the handling of the account.

In the case of the commercial depositor, it’s much like the system that Mr. Perkins described earlier, where the customer is given a theoretical earnings credit for that part of his balance that we are able to invest after allowing for reserve requirements and those items that have not actually been collected. That figure is set to one side and is used to offset the charges for the units of service made on the other side. If the total earnings credit is consumed, then we make a direct charge to the customer’s account for any deficit in his balance or in his earnings credit.

Senator RIEGLE. In a sense, then, you charge your customers for your services. If you look at it over the last 2 or 3 years, has there been a measurable increase in what you are having to charge them for what you do for them?

Mr. SHEA. Yes; there has been.

Senator RIEGLE. Could you express it in a percentage term roughly, just to give us an idea?

Mr. SHEA. I’d say 25 to 50 percent and it would be considerably larger than that except for the impact of extremely competitive environment in the correspondent banking fraternity.

Senator RIEGLE. What’s happened in your banks in this regard?

Mr. PRESTON. We have a little different philosophy. We don’t feel our service charge is our income. These are service charges on deposit accounts. We feel that we are paying our customer for the money he lets us use. In other words, if he has a balance of $100, we are paying him a service of 20 checks a month and two deposits or whatever he uses on his account. So this is a cost to us to get $100 to lend.

Our basic biggest problem is the interest we pay on savings. There are two kinds of costs for money. One is interest and the other is services, which amounts to tellers, capital facilities and so on. Our basic business is making loans. We pay for money. That’s a cost. We get our money back by charging for it when we loan it out. So the basic place we should recover any inflation or any other increased cost which would include these implied costs of Federal Reserve membership...
would eventually go to our loan customers, I would say, in our situation.

Senator RIEGLE. The loan customers in the sense that you would charge them a higher interest rate?

Mr. PRESTON. It would be a higher interest rate basically, which is a problem too because of unrealistic usury rates.

Senator RIEGLE. So let me ask, apart from the normal swings in interest rates, sort of the secular change in interest rates, are you finding in your bank that there's an upward creep in a sense in the cost that you're charging your customers which is inflation related—and I guess you're saying in effect that's showing up in the fact that the interest rate, all other things being equal, is higher because built into that is this increment.

Now, if so, what would that percentage increase look like in your bank over the last year or two?

Mr. PRESTON. I think it would be almost exactly the same as the inflation rate in the economy—6 percent a year, 7 percent a year, 8 percent a year, 10 percent 1 year. Most of our cost is interest which is affected definitely by inflation rates. The other costs are for people, machinery, supplies. I'd say basically the inflation is the same for our industry as any industry.

Senator RIEGLE. How about you, Mr. Donovan? What would be your experience there?

Mr. DONOVAN. We have definitely factored inflation in the system. About 18 months ago we discovered that after an attempt to raise our prices back to 1973 that had been aborted by the wage and price controls that went in at that time we had forgotten about it and toward 1975 and we were looking at declining earnings and increasing costs—we resurrected the pricing structure. At that time we instituted increases of roughly on the magnitude of 50 to 75 percent on specific services. At the same time, we formed a committee of internal officers connected with those areas that are cost sensitive and this committee reviews our service charges covering the whole gamut periodically and makes recommendations to management as to what we could do to recapture those costs. We definitely factor inflation in. We have to or we get killed.

Senator RIEGLE. So what would your cost increases over the last year or two look like, would you say, percentagewise?

Mr. DONOVAN. In the last 18 months we have increased costs probably after the initial jump somewhere on the magnitude of about 15 percent on some items over the last 2 years.

Senator RIEGLE. Now if we were to see a proposal passed then that would allow banks that are in the Federal Reserve System to receive a full interest payment, let's say at competitive rates, on their reserves that are held by the Federal Reserve, that would give you all a shot at additional money. I mean, it would be $14,000 in your case and larger in terms of larger banks. Would this money be used to lower the cost of services to customers? What would you do with that money or would that just be swallowed by the banks and make its way through the additional net income and retained earnings or dividends, or would you use that as a way to roll back maybe some of the price increases that you're having to pass on to people? What do you think would happen to that if you had that windfall?
Mr. Shea. The 2-percent provision?
Senator Riegle. I’m saying we went to a competitive rate. We actually paid a higher percentage. Let’s say you were paid a percentage rate that—I don’t know what that would be today, but 6 percent or something in that range.

Mr. Shea. Well, by and large, those dollars would be dollars that are already invested at comparable rates. There would be a substitution of funds. I don’t see there would be a net dollar improvement in our income.

Senator Riegle. The Fed is not paying you interest now. If they began to pay you interest on the money they are holding for you, wouldn’t that give you a sizable—

Mr. Shea. I think it would have an impact on Mr. Preston’s bank since he’s a member.

Senator Riegle. I’m saying if you were a member. I guess I’m postulating it in that fashion. I’m saying maybe the question is not a good one for you to deal with. I ought to be talking to somebody who’s in the Fed, but I’m wondering as a general proposition if the Fed were doing that, and let’s say you as a Fed bank were to become affiliated with the Fed, if this would have the effect that it would be a large enough item on a one-shot basis that it would actually benefit the consumer in the end in the sense the consumer would get a better break or does it basically benefit owners of bank shares? In other words, where would the money go once the Fed gave it to the bank? And I’m wondering if the competitive situation today and the anti-inflation spirit is such that a lot of bankers would say this is a great chance for us to roll back some of our recent price increases and get the cost of our services down because we’re not having to pay for something—in a sense, we’re not having to have our money sitting there idle and therefore we can afford to preserve our profit margins and lower our prices, or would the general response be inclined to be that this is a windfall and this is something that the people who own and run the bank get to keep?

Mr. Shea. If we were subject to universal reserve requirements, it’s our calculation that we would have to add roughly $10 to $12 million of reserves through the Federal Reserve which would be offset to some extent by reduced requirements that we would have to keep at other correspondent banks. I guess I’m getting back to my original point, it would be a substitution of dollars and really no net gain of income to us. There might be an income gain to the larger correspondent banks that have these tremendous deposits on balance at the Fed and in fact we would hope to see that and expect it would trickle through into the pricing system for correspondent banking services.

Senator Riegle. I appreciate what you’re saying with respect to your banking situation. How would you see it?

Mr. Preston. You’ve got me, because if you pass something like this, I’m going to get some money and you want to know where it’s going. I think it will eventually get thrown into the pot. It will go everywhere eventually. Shareholders will get some of it and should in dividends. The bank will keep most of it, in my opinion, and it will be part of our capital which increases our ability to serve the public with more loans. We’ll buy some machinery with it, automated tellers or whatever comes down the line. We need this money in our bank to
provide services and to provide extra profits. Eventually everybody will benefit, including our employees.

Mr. Donovan. I think that's a fair assessment, Senator. I think it will be spread among the various publics that a bank serves not only its own shareholders but its employees, its customers, through either reduced costs or improved services. I think one of the benefits that has been somewhat ignored and was touched on earlier in the testimony is capital ratios, that the banks will retain greater amounts of earnings in their capital structures and that will benefit the community itself, whether they're customers or not, because you will have a stronger community. Without earnings you can't have a strong bank, and I feel that it's an idea whose time has come.

Senator Riegle. But if somebody were to ask us the question about that we would not be able to say that that's necessarily the windfall to the consumers. In other words, they are not necessarily going to be the ones that end up in effect getting this on a passthrough.

Mr. Preston. You might think of it in terms of if we don't get it. There's a certain level of profits that every industry, every business must have. If we're $14,000 short somewhere, it would either come out of dividends, capital, which will get the Comptroller of the Currency on our neck, or we will have longer teller lines, old-fashioned systems—pick up your statement instead of mailing it. Eventually the consumer will suffer because after all stockholders and employees are consumers too.

Mr. Donovan. If it costs me 15 cents to process an item, whether I get money on my reserve balance from the Fed or not get money on my reserve balance from the Fed, it's going to cost me 15 cents to process the item, and I'm going to pass that through. Now, competitive pressures might restrict the amount that I can pass through, but it's difficult to make a categorical statement that the consumer will get all of it.

Senator Riegle. Apparently if the Fed were to pay competitive rates on reserves that it holds and then price explicitly for services and to do that properly, the revenue loss on paying competitive rates on reserves would cost the Government $1.8 billion, and the offset in pricing for services would be about $400 million. So if we were to talk in terms of what might be a very clean way of doing it, you're talking about an initial shortfall in terms of the Federal budget of $1.4 billion, which is a pretty stiff one, and I think probably under our current conditions, even if one were to make an argument that that was a theoretical desirable way to start to reengineer the system, I'm not sure that it's feasible or sound to take that kind of a shot. Although if that were not a consideration, it certainly has some appeal to me, that the idea that the funds kept ought to be paid at the competitive rate and in turn whoever is using the services ought to pay the fair cost for those services and people who take a lot pay for it and those who take less get paid for what they take and we would have the thing on sort of a rational footing.

The problem is how we get from here to there, and that's sort of where the debate seems to lie at the moment.

Let me pose some questions for you that Senator Proxmire is interested in having responses to.

Mr. Shea, you support universal reserve requirements with three limitations: (1) an exclusion for small banks; (2) an inclusion of
other financial institutions with regard to their transaction accounts; and (3) lower reserve requirements.

Let me ask you about all three of these. First, how big an exclusion would you prefer would be the first $10,000, $25,000, $50,000 deposits at each institution, or what figure?

Mr. Shea. I have no firm answer to that. I have been getting a crash course in the intricacies of this subject in the last few weeks, and I frankly wouldn't know where to draw the line other than state the principle that the smaller banks should not have to bear the same kind of burden or pressure that larger banks are subject to and are better able to deal with.

Senator Riegel. Should all savings deposits be considered transaction accounts? If not, how do you differentiate?

Mr. Shea. I can only speak to our own area where a large savings bank has a very widely distributed debit card which in essence opens up some indeterminate portion of their savings accounts to transactional definition, and I think that’s got to be looked at in terms of just what the impact is within that bank’s savings deposits. But this is a card widely distributed, widely used, and is used as cash. There’s somewhat of a discount paid by the merchant and credited to the depositor’s account as an incentive for the depositor to use it, and it is used. It’s a very good plan and I have nothing but compliments for it, but in looking at the other side of it, where do you draw the line between demand deposits and savings deposits?

Really, I’m turning the question back because I don’t know precisely how to deal with that.

Senator Riegel. What level of reserve requirements on transaction accounts and time accounts do you think is reasonable?

Mr. Shea. Well, the range now is 7 to 22 percent. I think that the range should be lowered substantially, perhaps down to zero—I’m talking of range now, not the actual number—to give the Fed the right to continue to move in a lower direction, and that the limit be brought down from 22 percent to some other reasonable number, whether it would be 8, 10, 12, I don’t know. You have experts who have appeared before you and who will probably appear later who would be able to give you a better answer to that.

Senator Riegel. Mr. Preston, what is your reaction to a proposal to exempt the first $50 million of deposits from reserve requirements to lower the reserve requirements ratios and to make such requirements mandatory and uniform for all depository institutions?

Mr. Preston. This would solve my problem. I see others though. The American Bankers Association represent not only me but 60 percent of the banks in the country who are nonmember banks. They have a real problem. You’re changing the rule to help me. The other thing I wonder about is: we’re using reserve requirements here as a tool to maintain Fed membership. Now, you can argue about reserve requirements, whether the Federal Reserve needs them or not in their monetary policy, but you may be giving up an important tool for the wrong reason. At this time, if there was any reason to change the reserve requirements, it would probably be up, not down, as this tool is used as a monetary control method. That would bother me a little bit on a nationwide-ABA level, but speaking as a small member banker—50 percent of the banks in the United States are under $25 million, and...
about 4 out of 10 of these are national banks or Federal Reserve member banks, it would solve our problem.

Senator Riegle. You said in your testimony, “If the bill passes as proposed, it may not stop membership attrition.” I'm wondering, do you believe that membership in the central bank is something that should be continued, or should we attempt to get affiliation with the Federal Reserve for all banks?

Mr. Preston. I think you should have a choice. The Federal Reserve might do something that is counterproductive in our opinion, and we should have a place to go. I think that State bankers are like I am—they believe in their system. They use it well and it's valuable to them. They should have the choice as far as the regulatory part. As reserves requirements go, it's too bad mandatory reserves weren't started 100 years ago. We wouldn't have this problem and the Fed would have more interest.

Senator Riegle. Mr. Donovan, you argue in your testimony that nonmembers as well as members should be allowed to invest reserves in its correspondent banks. Can you explain to us why you see this as being important?

Mr. Donovan. I think my testimony addressed that issue, Senator, and to repeat it, the definition—we're throwing terms around here that are confusing people, but the definition in the bill of the depository institution covers the whole gamut of what's nicely known as banks. It covers commercial banks. It covers savings banks, S. & L.'s, and it covers credit unions.

Now at the present time I have a substantial number of savings banks, credit unions, and S. & L.'s in the State of Maine as my customers. Now all of a sudden you're going to tell them that the balance they maintain in Casco Bank, which is a nonmember, is a tainted balance because they cannot use that balance in computing their reserve assets. So all of a sudden I'm discriminated against and, as I say in there, we have 110 accounts in this category and we have $8.5 million in balances which I stand the risk of losing, and I will lose overtime, because it's not as attractive as a balance that they would have across the street at Maine National which is a member bank.

Senator Riegle. Is the lack of access to Federal Reserve services adversely affecting your bank?

Mr. Donovan. No. We can obtain those services through our correspondent banks, and we are permitted, if we put the items in machine form, to clear through the RPCP that the Fed maintains in Maine, but we are not at a disadvantage.

Senator Riegle. If you had access to Fed services, do you think you would use them?

Mr. Donovan. There are certain services we would use certainly and we pay a price for them now indirectly. We order currency and coin through the Fed in Boston and the only difference between me and a member bank is that I pay hard dollars for them to Brinks and they get the Fed to pay for it. We maintain some safekeeping at Fed through Fed member banks and if we had to pay for it we probably still would, and I think we would continue to use the services that we use. We might consider whether we would send more items to the Fed for collection as opposed to sending them to correspondents, but we'll really get a better availability of funds out of correspondents.
Senator RIEGLE. Mr. Shea, let me ask you the same question. Does the lack of access to Federal Reserve services adversely affect your bank?

Mr. SHEA. Not at all. As I outlined in my remarks, this was a major consideration before we made the move to be sure that we wouldn’t be impacted adversely in the availability of services and through the use of correspondent banks we have been able to actually enhance the collection effectiveness. We have reduced costs in some areas. We were able to substitute for the lack of access to the discount window through the arrangement of large credit lines for reserve purposes with major correspondents and are satisfied that in every respect the service was as good or perhaps even better than we had experienced as members of the Federal Reserve. I’m talking about 1972 conditions.

Senator RIEGLE. Are you saying then that you’re not necessarily in a position to make a comparative assessment as to the efficiency now of the Fed in providing the services versus the correspondent banks?

Mr. SHEA. No; for this reason: The operating procedures of the Fed, as with all banks, change from time to time as new transportation schedules become available, and they offer you different options as to how you break your work down before you send it to them or whether it’s more advisable to send work directly to another bank, and these operating circulars and manuals are constantly being rewritten to reflect these changes. But at that time the statement is true that we could match and exceed the service we were getting.

Senator RIEGLE. Mr. Donovan, commenting as a nonmember institution, should the discount window be open for all depositories and, if so, what requirements should be established for that usage?

Mr. DONOVAN. To quote the Fed, the discount window is a privilege, not a right. That’s what they tell you when you go there, and the requirements of borrowing in the Fed are not any big deal. I mean, you go in there and you borrow for a short period of time and you pledge liquid collateral. Now there is a certain mystique connected with the fact that the Fed is the lender of last resort and you would like to think you would be able to get money from them if it was that type of a situation. I think that presently I could go to the Fed today and I could borrow provided they advanced the credit to me. What is my penalty for not being a member? It’s two points over the discount rate. I think the thing that you will never be able to legislate is the attitude that the district Federal Reserve bank has in welcoming nonmembers at the discount window, and maybe if it’s in the statute that they have to accept us as first class citizens then there might be an advantage to it. Borrowing arrangements are available from correspondent banks. We too have liquidity lines established that satisfy our needs if we should ever have to use them, and so far we have not had to use them; but we compensate the correspondent bank for those credit lines that are available.

I think it would be nice to have the window, at least in theory, open to all depository institutions, but it’s really not that necessary.

Senator RIEGLE. Let me ask any of you that want to respond if there should be a similar unbundling applied to correspondent services as at least some people want to apply to Fed services and, if so, in what manner could that kind of a project proceed?
Mr. DONOVAN. Senator, I think there is unbundling now. I think that’s a misconception by whoever wrote the question. I know so. I pay hard dollars for the services I get from correspondent banks. We do get an earnings credit on the balance, but we keep our balances at certain correspondents down to the bare minimum to cover items in transit and we compensate them with a check at the end of the month.

Now assuming that the Fed unbundled, would my prices change? I think there’s a possibility that would happen. They might change by increasing, only because the value of the balance might change. But it’s a misconception on somebody’s part that there is this term unbundling between correspondents.

Senator RIEGLE. So you say it could be a much cleaner situation.

Mr. DONOVAN. It’s a whole lot cleaner in the private sector because it is competitive. The Fed has no competitors. I mean, you belong, you get to use what you want. If you don’t, there’s no benefit to you.

Senator RIEGLE. I have noticed that they can be a bit highhanded. Do either of the other two of you want to comment on that?

Mr. SHEA. Only to confirm what Mr. Donovan said.

Mr. PRESTON. I would confirm it. It’s a different system but it’s a free choice. You don’t pay dollars and get interest, but it’s the same effect.

Senator RIEGLE. We may have some additional questions that other members of the committee would want to have you respond to for the record, but I have nothing more now at this time myself. So let me thank each of the three of you for appearing today and for coming and giving us your testimony. It’s been very helpful to us and we appreciate it.

The committee stands in recess.

[Whereupon, at 12:30 p.m., the hearing was recessed, to be reconvened at 10 a.m., Wednesday, August 16, 1978.]
FEDERAL RESERVE REQUIREMENTS ACT OF 1978

WEDNESDAY, AUGUST 16, 1978

U.S. SENATE,

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,

Washington, D.C.

The committee met at 10 a.m. in room 5302, Dirksen Senate Office Building, Senator William Proxmire, chairman of the committee, presiding.

Present: Senators Proxmire, Brooke, Riegle, and Sarbanes.

The CHAIRMAN. The committee will come to order. This is the committee's third day of hearings on proposals related to reserve requirements and Federal Reserve membership.

Thus far there is no clear consensus on a solution. There is agreement that the special problems on small banks and thrifts must be recognized and that in general reserve requirements set by the Federal Reserve should be lower than they are now.

The banks would like to receive interest on reserves, but that is not seen as a permanent solution to the Federal Reserve's problem of attrition of members. Moreover, the precedent of some interest payment would surely lead to additional demands for larger interest payment in the future.

Our first witness today is the Honorable Robert Carswell, Deputy Secretary of the Treasury. Mr. Carswell, I am sure that the Treasury and the administration would be concerned if the Congress landed the banking community $1.8 billion, which is the market return on reserves at the Federal Reserve. We will be especially interested in what you may suggest as an alternative solution to help the Federal Reserve.

Mr. Carswell, you may proceed as you like. We would appreciate your taking about 10 minutes in your oral presentation.

Before you begin, Senator Brooke, the ranking member of the committee, has a statement. Both Senator Brooke and I are going to be relieved by other Senators a little later, because we both will be required in a markup of the Defense appropriations bill this morning. Senator Brooke.

STATEMENT OF SENATOR BROOKE

Senator Brooke. Thank you, Mr. Chairman. Mr. Chairman, after several years' discussion by the Federal Reserve Board Chairman and others of the problem of declining Federal Reserve System membership, I am pleased that we are promptly holding these hearings on the comprehensive proposal of the Board to resolve the membership problem. Furthermore, we should note that the Housing Banking Com-
mittee has already begun markup of this proposal. In view of the importance of this legislative issue, I hope this committee will treat the Federal Reserve Board proposal with promptness as well.

After more than a decade of decline in the number of banks that are members of the Federal Reserve System, the need for attention to this problem is quite obvious. The Board reports that in the last 10 years, 551 banks have withdrawn from membership. The proportion of commercial bank deposits held by member banks has declined from 83 percent to 73 percent. We may not know the precise point at which declining Federal Reserve System membership seriously weakens control over monetary policy, but in a period with deep problems in our economy, we must maintain the strength of the Nation's central banking system.

To respond to this threat to the central banking system, the Federal Reserve proposes a four-part plan. First, interest would be paid on required reserves.

Second, reserve requirements for member banks would be reduced in two stages.

Third, explicit prices for Reserve System services would be imposed.

Finally, universal reserve requirements would apply to all demand deposits, share drafts, and NOW accounts whether held by member banks or not.

I would like to discuss each of these elements of the Board's proposal in turn.

First, I strongly support permitting banks to receive interest on required reserves. This is clearly the most important element of the Board's proposal to prevent further attrition from the Federal Reserve System. Member banks are now seriously disadvantaged by maintaining substantial non-interest-earning reserves. November financial institutions generally are allowed to hold reserves in the form of low risk, but nonetheless interest-earning assets. The competitive disadvantage to member banks is apparent in the consistently lower average profits of member banks compared to nonmember banks.

This unequal treatment has become particularly important in recent years. First, persistent inflation and generally high interest rates have increased the costs, in lost earnings, from keeping reserves in the Federal Reserve System. Second, competition in banking has increased dramatically, especially through the growth of the savings industry and the credit unions. I would add that this heightened competition is, to some degree, a direct result of congressional action encouraging formation of these competing financial institutions. I am not suggesting that competition should be curtailed. We must recognize, however, that our actions have increased the attention which the financial institutions must give to earnings on all assets, including reserves. Permitting banks to earn interest on required reserves can reverse this unequal treatment of member banks, and significantly reduce the burden of membership in the Federal Reserve System.

As indicated in your opening statement yesterday, it is apparently your view, Mr. Chairman, that the Treasury already gets the Reserve System's earnings on these reserve deposits, so why give any of it back to the banks? The Chairman's view on this issue, in my opinion, could not be more wrong. From this perspective, non-interest-bearing
reserves amount to little more than a hidden tax on some of the Nation's banks. We must remember, though, that the Treasury has no claim granted by Congress to take these funds from the banking system. Furthermore, continued erosion of the membership is reducing the Reserve System's payments to the Treasury.

I also support the second part of the Board's proposal which would gradually simplify and reduce reserve requirements for member banks. This would further ease the burdens of membership, particularly for smaller banks. I note that the Board would adjust open market operations to assure a neutral effect on monetary policy during the phasing in of these reserve requirement modifications.

With regard to pricing Federal Reserve System services, I am also in basic sympathy with the Board's proposal. From the standpoint of efficiency it certainly makes sense to me to charge for services used by financial institutions. Furthermore, as check volume continues to grow and new electronic funds transfer systems develop, this is a keytime to encourage development of private sector alternatives to Reserve System domination of payments-clearing functions. Private sector competition can only develop, however, in an environment of pricing by the Federal Reserve that reflects all System costs for services.

Finally, the Board proposes "universal reserve requirements" that would apply to transaction accounts of all financial institutions, whether member banks or not. This, I am sure, is the most contentious element of the Board's proposal, because it removes from the majority of the Nation's financial institutions the choice of whether to contribute to the Federal Reserve System. Certainly legislation requiring de facto participation in the Reserve System by all banks would substantially solve the membership problem. However, it would also significantly alter the basic structure of the banking system, and possibly tilt the balance between State and National bank chartering too far against the State system.

I will keep an open mind on this element of the Board's proposal, but hope that it proves to be unnecessary. A careful structuring of incentives for Reserve System membership through interest on reserves and reduced reserve requirements should correct the problem of membership attrition. I believe we should authorize these incentives and the rationalization of pricing for Reserve services. If these actions prove insufficient to correct the membership problem, then we can reexamine universal reserve requirements or other measures which by legislative fiat insure adequate central banking system control over our monetary policy.

Mr. Chairman, let me repeat that I appreciate these prompt hearings on this important legislation. The problem of declining Federal Reserve System membership should be resolved this year. The time is now ripe to resolve these significant banking issues, and I hope the committee will proceed quickly to formal consideration of the legislation.

I regret that I will not be able to stay through the competition of your testimony, Mr. Carswell, and to ask questions. I would like to submit some questions for the record, if I may.

I would also like to welcome the Comptroller. I always enjoy meeting with him and having an exchange with him. Of course I want to
acknowledge the presence of our Banking Commissioner from the Commonwealth of Massachusetts, for whom I have the highest esteem, admiration, and respect.

Thank you, Mr. Chairman.

The CHAIRMAN. Before you depart, Senator Brooke, this is a very interesting opening statement. The trouble is we can always solve problems by spending money, the taxpayers’ money. Here we go again.

If we are going to give the bankers something they have never had before, ever, that is, interest paid by the Federal Government on the reserves they are required to keep, it is a precedent that is going to be very, very hard to hold down.

The Federal Reserve indicates the cost now would be relatively modest, but it is likely to be a very heavy cost indeed. And to argue that the banks have an absolute right because their reserves are sterilized doesn’t make any sense on the basis of precedent or on the basis of policy. The banks, after all, do have a great privilege, they are not forced to be bankers, nobody forces a bank to be chartered. They do it because they recognize it is a good thing, a very good thing. And the requirement that they hold reserves is something we have had, as I said, perpetually, and it is a system that has worked rather well.

For us to abandon that, especially in view of the fact that the consideration we can give to it in the closing days of this session would be abbreviated, it seems to me is a profound step that we should be very, very careful in taking, and recognize the serious cost that this may impose on the Treasury and ultimately, of course, on the general taxpayer.

Senator Brooke. I recognize that. But you also recognize the erosion of Reserve System membership. I am sure you are aware of it; you have been concerned about it, as I have, and many others. The questions is: What is a viable alternative?

The CHAIRMAN. Well, I think there is a viable alternative, and the alternative suggested by both the House Banking Committee Chairman and by the Chairman of the Federal Reserve as an alternative would not, as I understand it, require interest to be paid on reserves, but would require an exemption from having any reserve requirements for small banks, No. 1, and, No. 2, would provide uniform reserve requirements on all banks of the same size, which it seems to me would be equitable and fair. But that is something we can debate and discuss.

Senator Sarbanes?

Senator Sarbanes. I have no comments at this time.

The CHAIRMAN. Mr. Carswell, I apologize for detaining you. Go right ahead, sir.

STATEMENT OF ROBERT CARSWELL, DEPUTY SECRETARY, DEPARTMENT OF THE TREASURY

Mr. CARSWELL. I am pleased to present the views of the administration on S. 3304, introduced at the request of the Federal Reserve Board.

That bill authorizes actions to eliminate the incentive for commercial banks to withdraw from the Federal Reserve System.

Since June of last year, when this committee considered this problem, the trend toward lower Federal Reserve membership has continued, and in the last 12 months more than 60 commercial banks have voluntarily withdrawn from the system.
We understand that additional member banks are considering doing so, but have delayed their decision until after the Congress responds to the bills such as S. 3304, that are presently before it in this area.

Previous witnesses have reviewed the burden imposed on National and State-chartered member banks by the requirement that they hold non-interest-bearing reserves in the Federal Reserve System. The burden has been heightened by the advent of high interest rates, which have increased the opportunity cost to member banks of reserves that cannot be employed to generate income. As a result, the effective cost of deposits to member banks is higher than for nonmembers.

The administration believes that the continuing attrition in Federal Reserve System membership will endanger the pivotal role in our financial system played by the Federal Reserve. The Treasury believes that requiring mandatory reserves for all but the smaller depository institutions is the preferable method of dealing with that problem.

If the Congress does not adopt that approach, the administration supports the enactment of legislation that would, first, lower reserve requirements, and second, explicitly grant to the Federal Reserve the authority to pay interest on member bank reserve balances. The legislation should, however, limit the potential revenue loss to the Treasury and provide standards for the Federal Reserve to follow in setting the appropriate levels of interest payments and reserve requirements.

The administration also agrees that the Federal Reserve should move to impose explicit charges for each of its services, with appropriate safeguards to provide for an orderly transition from the present system.

The role of the Federal Reserve System as the central bank has been critical in this country, both as the overseer of the money supply at the discount window and as an institution that maintains close relations with and provides counsel to a large spectrum of the banking community through its Federal Reserve banks, and also through the extension of services to its members.

Each of these functions plays a part in fulfilling the Federal Reserve’s responsibilities for integrity and control of the monetary system. Each is eroded by the continuing decline in membership.

While, as Senator Brooke said, none of us can pinpoint the moment when a worrisome trend becomes an alarming event, it is clear that at some point the stature and power of the central bank will become more attenuated as the trend proceeds. This weakening of the role of the Federal Reserve in our banking system should be arrested.

As I have said previously, the Treasury believes that the approach of universal reserve requirements is the preferable one. The Federal Reserve has proposed legislation that would require all depository institutions, whether or not members, to comply with mandatory Federal Reserve requirements against transaction accounts. Nonmember reserves would be held at the Federal Reserve banks or at member banks, which would in turn hold the reserve at a Federal Reserve bank.

The Treasury supports in principle the imposition of uniform reserve requirements on similar types of deposits at institutions of comparable size, regardless of the type of depository institution holding the deposits. The Federal Reserve’s effectiveness in the conduct of monetary control would be strengthened by requiring universal reserves.
This approach will provide a permanent solution to the impact of the membership problem on the conduct of monetary policy. If severs the link between Federal Reserve membership and the separate issue of the appropriate level of reserve requirements necessary for the conduct of monetary policy. It avoids the necessity—which arises if the problem is to be met by the payment of interest on reserves—of requiring the Federal Reserve to compute the differing burdens of membership for different banks to insure that the interest payments and other benefits are properly targeted.

Another advantage of a universal reserve requirement is that this approach is significantly less costly to the Treasury than the alternatives. Nevertheless, even under a universal reserve structure, a substantial reduction in reserve requirements, or even the payment of interest, may be required to reduce the impact on smaller nonmembers of meeting reserve requirements.

Finally, it would eliminate the present inequities between treatment of members and nonmembers with respect to reserves, while continuing to vest responsibility for supervision and regulation of nonmembers with the FDIC and State bank supervisors.

Of course, there are a number of issues that remain to be resolved. One very important question is the extent to which smaller institutions may be exempted from reserve requirements in order to avoid the adverse impact on earnings that would flow from a change. Another is whether the universal reserve requirement should extend to deposits other than transaction accounts. In addition, the interaction of this proposal with the separate questions of Federal Reserve membership and access to Federal Reserve services must be closely examined.

Other issues include the place at which reserve balances should be held, the form in which reserves are held, (some have argued in favor of permitting Treasury securities to be used as reserves), the degree of reduction in reserve requirements, the degree of uniformity in reserve ratios, and the amount of interest, if any, paid on required reserves.

Despite these unanswered questions, this is a straightforward and workable approach to a complex problem. We would be glad to assist you and your staff in seeking answers to these difficult questions.

However, if the Congress should decide that nonmember banks and thrift institutions should continue to be exempted from reserve requirements of the Federal Reserve, then the administration supports legislation to reduce the financial burden of membership on those banks that would otherwise leave the system.

One approach contained in S. 3304 is to lower reserve requirements and to permit the Federal Reserve to pay interest on its required reserves. This approach will initially be more costly than universal reserves. There is no reason to believe that the precise level of interest payments and reserve requirements which serve to stabilize Federal Reserve membership can be readily identified and it is likely that pressures for additional payments or reserve changes will build in the future.

The Federal Reserve's proposal is similar in design and cost to the program contained in title II of the NOW account bill introduced last year. I will omit summarizing the proposal, because I am sure you have heard it endlessly from previous witnesses, and go on to comment on that proposal.
Any payment by the Federal Reserve of interest on reserves, and any reduced earnings from lower reserve balances will, of course, result in the reduction of payments to the Treasury.

On the other hand, increased income received by member banks as a result of such a program will lead to their paying additional taxes to the Treasury. We estimate that over time the Treasury will recapture approximately one-half of these benefits through the tax system. Based on the estimated cost of the Federal Reserve proposal of $675 million, we estimate that the net cost to the Treasury, after tax recapture, will be about $335 million per year.

When Secretary Blumenthal testified last year on S. 1664, he stated that the administration would accept a net revenue loss of some $200 to $300 million in order to solve the membership problem of the Federal Reserve.

As I noted, approaching the problem through the requirement of universal reserves will reduce the cost to the Federal Government, but we continue to believe that incurrence of a significant cost is warranted to solve this problem.

The aggregate cost to the Treasury should, however, be subject to an appropriate limit, and should also take into account that the loss of revenue to Treasury can accrue from a reduction in reserve requirements just as easily as from the payment of interest on the reserves.

We also believe that any plan based on the payment of interest on reserves should take into account that different classes of banks receive differing benefits from Federal Reserve membership. Thus, use of the discount window may well be more important to a larger bank that may borrow in an emergency situation from its larger correspondent.

There is considerable room for debate about the appropriate amount necessary to stem the membership loss and whether payments should be the same to all banks or targeted to that class of bank where membership attrition is most probable.

We would be pleased to discuss with your staff further possible ways to target payments to reduce the cost to the Treasury.

On the pricing issue, the administration believes that imposing explicit charges for services rendered by the System will impose a useful discipline on users of the service. It will also permit private vendors of these services to compete on an equal basis. At the present time private participation has been constrained by the difficulty of competing with a Government agency offering free services. We would suggest, however, the committee consider alternative methods by which such pricing may be phased in, so that unnecessary disruption in the system can be avoided.

The administration is, in principle, in favor of open access to Federal Reserve services for all nonmembers at nondiscriminatory prices. That issue must be resolved, however, in the context of the effectiveness of the steps taken to stem the reduction in membership. If access to services is no longer an advantage of membership, then this change may increase the outflow of members unless the other disadvantages have been fully offset.

That concludes my formal testimony, Mr. Chairman.

[The complete statement of Mr. Carswell follows:]
STATEMENT OF ROBERT CARSWELL, DEPUTY SECRETARY OF THE TREASURY

I am pleased to present the views of the Administration on S. 3304, introduced at the request of the Federal Reserve Board. That bill authorizes actions to eliminate the incentive for commercial banks to withdraw from the Federal Reserve System.

In June of last year, this Committee considered S. 1664, which had the dual purpose (1) of authorizing financial institutions to maintain NOW accounts and (2) of reducing the cost of Federal Reserve membership by lowering the range of statutory reserve ratios and by permitting the Federal Reserve to pay interest on required reserves. This Committee acted promptly, and favorably, on that legislative proposal, which Administration supported, and reported out a bill in mid-August of last year. No further action has been taken.

Since that time, the trend toward lower Federal Reserve membership has continued. In the last 12 months, more than 60 commercial banks have voluntarily withdrawn from the System. We understand that additional member banks are considering doing so, but have delayed their decision until after the Congress responds to the bills, such as S. 3304, that are presently before it in this area.

Previous witnesses have reviewed the burden imposed on National and state chartered member banks by the requirement that they hold non-interest bearing reserves in the Federal Reserve System. The burden has been heightened by the advent of high interest rates, which have increased the opportunity cost to member banks of reserves that cannot be employed to generate income. As a result, the effective cost of deposits to member banks is higher than for nonmembers.

SUMMARY OF CONCLUSIONS

The Administration believe that the continuing attrition in Federal Reserve System membership will endanger the pivotal role in our financial system played by the Federal Reserve. The Treasury believes that requiring mandatory reserves for all but the smaller depository institutions is the preferable method of dealing with that problem.

If the Congress does not adopt that approach, the Administration supports the enactment of legislation that would (1) lower reserve requirements and (2) explicitly grant to the Federal Reserve the authority to pay interest on member bank reserve balances. The legislation should limit the potential revenue loss to the Treasury and provide standards for the Federal Reserve to follow in setting the appropriate levels of interest payments and reserve requirements.

The Administration also agrees that the Federal Reserve should move to impose explicit charges for each of its services, with appropriate safeguards to provide for an orderly transition from the present system.

THE IMPACT OF A DECLINING MEMBERSHIP ON THE FEDERAL RESERVE

In the aftermath of the banking reforms that began with the Federal Reserve Act in 1913 and continued after the Depression, the financial system of the United States has become the strongest in the world. Bank regulators at the Federal and state levels have played an important part in that development. The role of the Federal Reserve System as the central bank has been critical—as the overseer of the money supply and discount window; as an institution that maintains close relations with, and provides counsel to, a large spectrum of the banking community through its regional Federal Reserve Banks; and through the extension of its services to members.

Each of these functions plays a part in fulfilling the Federal Reserve's responsibility for the integrity and control of the monetary system. Each is eroded by the continuing decline in membership. We cannot pinpoint the moment when a worrisome trend becomes an alarming event. In all likelihood, there is no such single point. But the stature and power of the central bank will become more attenuated as the trend proceeds. This weakening of the role of the Federal Reserve in our banking system should be arrested.

I would now like to turn to the specific legislative issues before this Committee.

UNIVERSAL RESERVES

The Federal Reserve has proposed legislation that would require all depository institutions—whether or not members—to comply with Federal Reserve requirements for reserves against transaction accounts. Nonmember reserves would be
held at the Federal Reserve Banks or at other member banks which would, in
turn, hold the reserves at a Federal Reserve Bank.

The Treasury supports, in principle, the imposition of uniform reserve require­
ments on similar types of deposits at institutions of comparable size regardless of
the type of depository institution holding the deposits. The Federal Reserve’s
effectiveness in the conduct of monetary control would be strengthened by re­
quiring universal reserves.

This approach will provide a permanent solution to the impact of the mem­
bership problem on the conduct of monetary policy. It severs the link between
Federal Reserve membership and the separate issue of the appropriate level of
reserve requirements necessary for the conduct of monetary policy. It avoids the
necessity—which arises if the problem is to be met by the payment of interest on
reserves—of requiring the Federal Reserve to compute the differing burdens of
membership for different banks to insure that the interest payments and other
benefits are properly targeted.

Another advantage of a universal reserve requirement is that this approach is
significantly less costly to the Treasury than the alternatives. Nevertheless,
even under a universal reserve structure, a substantial reduction in reserve re­
quirements (or even the payment of interest) may be required to reduce the
impact on smaller nonmembers of meeting reserve requirements.

Finally, it would eliminate the present inequities between treatment of members
and nonmembers with respect to reserves while continuing to vest responsibility
for supervision and regulation of nonmembers with the FDIC and State bank
supervisors.

Of course, there are a number of issues that remain to be resolved. One very
important question is the extent to which smaller institution may be exempted
from reserve requirements in order to avoid the adverse impact on earnings that
would flow from a charge. Another is whether the “universal” reserve require­
ment should extend to deposits other than transaction accounts. In addition, the
interaction of this proposal with the separate questions of Federal Reserve
membership and access to Federal Reserve services must be closely examined.

Other issues include the place at which reserve balances should be held, the
form in which the reserves are held (some have argued in favor of permitting
Treasury securities to be used as reserves), the degree of reduction in reserve
requirements, the degree of uniformity in reserve ratios, and the amount of
interest, if any, paid on required reserves.

Despite these unanswered questions, this is a straightforward and workable
approach to a complex problem. We would be glad to assist you and your staff in
seeking answers to these difficult questions.

**PAYMENT OF INTEREST ON RESERVES AND REDUCTION IN RESERVE REQUIREMENTS**

If the Congress should decide that nonmember banks and thrift institutions
should continue to be exempted from reserve requirements of the Federal
Reserve, then the Administration supports legislation to reduce the financial
burden of membership on those banks that would otherwise leave the System.
One approach, contained in S. 3304, is to lower reserve requirements and to
permit the Federal Reserve to pay interest on its required reserves.

This approach will initially be more costly than universal reserves. There is no
reason to believe that the precise level of interest payments and reserve require­
ments which serve to stabilize Federal Reserve membership can be readily identi­
ified and it is likely that pressures for additional payments or reserve changes
will build in the future.

The Federal Reserve’s proposal is similar in design and cost to the program
contained in Title II of the Administration’s NOW account bill introduced last
summer. The Federal Reserve Banks would begin paying interest on required
reserves and reserve requirements on demand deposits would be simplified and
reduced. Services now provided at no cost to member banks would begin to be
sold to members—and perhaps eventually to others—at prices set by the Federal
Reserve.

During the first phase, reserve requirements would be reduced to release ap­
proximately $3 billion in reserves. The Federal Reserve Banks would also begin
paying an interest rate of 2 percent on all required reserve balances held by
them. At present deposit levels, these payments would equal approximately $430
million.
As the program becomes fully implemented, the interest rate paid on the first $25 million of a bank's reserves will be raised to a level equal to one-half of 1 percent below the yield on the Federal Reserve's securities portfolio. Reserve requirements will be further reduced to release an additional $2 billion in reserves to member banks.

Under present conditions, the Federal Reserve estimates that total interest payments to member banks under the fully phased-in program would equal about $765 million annually. The increased member bank earnings from the released reserves will provide an additional $320 million in earnings, but member banks will probably pay about $410 million to the Federal Reserve in service charges. The net benefit to banks is therefore estimated to be approximately $675 million. Interest payments would be limited to not more than the sum of the System's receipts from charges for services purchased by members plus 7 percent of its annual net earnings.

To reduce the initial impact of the program on the Treasury and the Federal deficit during the transition period, the Federal Reserve will finance the program's estimated after-tax cost by paying the Treasury about $575 million from its accumulated surplus.

THE COST TO THE FEDERAL GOVERNMENT

Any payment by the Federal Reserve of interest on reserves, and any reduced earnings from lower reserve balances, result in a reduction of payments to the Treasury. On the other hand, the increased income received by member banks as a result of such a program will lead to their paying additional taxes to the Treasury. We estimate that over time the Treasury will recapture approximately one-half of these benefits. Based on the estimated cost of the Federal Reserve proposal of $675 million, we estimate that the net cost to the Treasury, after tax recapture, will be about $335 million per year.

When Secretary Blumenthal testified last year on S. 1664, he stated that the Administration would accept a net revenue loss of some $200-300 million in order to solve the membership problem of the Federal Reserve. As I noted, approaching the problem through the requirement of universal reserves will reduce the cost to the Federal government, but we continue to believe that incurrence of a significant cost is warranted to solve this problem.

The aggregate cost to the Treasury should, however, be subject to an appropriate limit and should also take into account that the loss of revenue to Treasury can accrue from a reduction in reserve requirements just as easily as from the payment of interest on the reserves. We also believe that any plan based on the payment of interest on reserves should take into account that different classes of banks receive differing benefits from Federal Reserve membership. Thus use of the discount window may well be more important to a larger than to a smaller bank that may borrow in an emergency situation from its larger correspondent.

There is considerable room for debate about the appropriate amount necessary to stem the membership loss and whether payments should be the same to all banks or targeted to that class of bank where membership attrition is most probable. We would be pleased to discuss with your staff further possible ways to target payments to reduce the cost to the Treasury.

PRICING OF FEDERAL RESERVE SERVICES

Imposing explicit charges for services rendered by the System will impose a useful discipline on the users of the services. It will also permit private vendors of these services to compete on an equal basis. At the present time, private participation has been constrained by the difficulty of competing with a government agency offering free services. We would suggest, however, that the Committee consider alternative methods by which such pricing may be phased-in so that unnecessary disruption in the system can be avoided.

The Administration is, in principle, in favor of open access to Federal Reserve services for all non-members at nondiscriminatory prices. That issue must be resolved, however, in the context of the effectiveness of the steps taken to stem the reduction in membership. If access to services is no longer an advantage of membership, then this change may increase the outflow of members unless the other disadvantages have been fully offset.

That concludes my formal testimony, Mr. Chairman. I would be pleased to answer any questions the Committee may have.
The CHAIRMAN. Thank you, Mr. Carswell.

Mr. Carswell, when Chairman Miller appeared, he was very frank, as is his manner, and he said that membership really isn't essential and it is rather unique in the United States in terms of central bank functions.

He admitted this was the only country he could think of in which we have membership as a key, as it has been here, to monetary policy. So he said it would be appropriate for us to think more broadly.

Do you agree that the concept of membership is an idea no longer as essential as it seemed to be in the past?

Mr. Carswell. I think in general, yes. But there are things that the Federal Reserve does, or has the power to do, that are identified in the statutes with its powers over member banks, such as regulation Q, for instance.

If we start divorcing the issue of a declining membership from reserve requirements, we will have to look at other sections of the statute.

So there is some sorting out to do. But in principle there isn't any real reason to identify the central bank's primary function of monetary policy with a membership system. But in our present regulatory system, the two are interwoven. If you are going to separate the two, you have to look at other ones as well.

The CHAIRMAN. I presume you have had a chance to look at both Chairman Reuss' proposal and Chairman Miller's proposal.

Chairman Reuss, as I understand it, made a proposal for a universal reserve at a certain specific level for everybody, with $100 million exemption, and with the reserve requirement applied against time and demand deposits.

The Federal Reserve proposal was for a $50 million exemption, but with reserves applied apparently with a differential between time and demand deposits.

Apparently they both would have about the same effect on the Federal Reserve revenues.

Can you tell us which approach you prefer?

Mr. Carswell. I and our staff have looked at them both. We are not satisfied that we have the final figures to be sure exactly what the costs of the proposals are, and we really haven't had a chance to go through all of the figures we have gotten so far. The Federal Reserve's analysis of the two proposals has not been completed.

The CHAIRMAN. Are they roughly similar?

Mr. Carswell. They appear to be roughly similar in price. But it depends on some subtleties which I don't think are clear yet.

The CHAIRMAN. They both would cost something more than the present cost?

Mr. Carswell. Yes.

The CHAIRMAN. Therefore the implication of that is the banks would gain from either of these proposals?

Mr. Carswell. They would gain, presumably.

The CHAIRMAN. They would gain as the Federal Reserve loses.

Mr. Carswell. That is correct. The cost to the Treasury would be reduced by about half because of higher tax receipts.
The CHAIRMAN. So this could not be considered any punitive action. It would be a benefit to them, and wouldn't it seem in both cases it would provide for a degree of equity among all banks of all sizes?

Mr. CARSWELL. Yes; we have advised Chairman Reuss that we are in favor of pursuing his approach. I talked at length with Chairman Miller about it, and there are elements of his proposal which we would prefer to Chairman Reuss', because we think they would be more equitable, and would better solve some of the problems. If you applied a single reserve requirement to all time savings and demand deposits, that will create problems of competitive inequities. We think Chairman Miller's approach in that respect would probably be better.

The CHAIRMAN. You heard Senator Brooke speak this morning and yesterday Senator Lugar gave a similar view. I am concerned, as I indicated, that we may go the interest on reserves way, and there may well be pressures from the banks and others to do this, I have seen this happen in the past, this kind of thing.

The Federal Reserve proposal originally called for an artificial 2-percent rate, not the market rate. But wouldn't such an artificial arrangement designed at first to hold down the costs, wouldn't there be great pressure to bring it up to the market rate, so that the market rate would be paid on reserves eventually?

Couldn't we expect under those circumstances a substantial loss? I calculate about a $1.5 billion loss if you do it that way.

Mr. CARSWELL. As I said in my testimony, obviously we would prefer a universal reserves approach. I am afraid if we go the payment of interest on reserves way, it will be reopened from time to time as you suggest, because competitive forces will change, and other differences will come into play.

There is no doubt that the Federal Reserve also will from time to time run into situations where it would like to change the level of reserve requirements. If it should increase reserve requirements, the costs to the banks will rise, and that will lead to pressures on the Federal Reserve to raise the interest rates, and so on.

I think in a fluid type of situation, that we can anticipate in the future, that as the Federal Reserve does its job of changing monetary policy as necessary, there will be pressures to raise the subsidy provided by interest payments.

The CHAIRMAN. Let me ask for your judgment as an economist on this: If we should adopt a policy of providing interest on reserves of several hundred million dollars, who would benefit from it in your judgment? Would it be the bank stockholders, or would it be the people who use bank services, the customers, or would it be a combination of the two, or is this not clear?

Mr. CARSWELL. I assume it would vary, depending on the bank and what it did. There are banks that don't pay income taxes, for instance, because of tax loss carryforwards, and investments in municipal bonds and so on. For them you are going to get a different incidence of benefit from the payment of interest than you would for a bank which pays up to 50 percent of income in taxes.

So I don't think you can be sure exactly what the benefits will be in each class of bank. Obviously it will mean additional income to the bank.
What the bank does with the money depends on its management. It may pay dividends, it may lower prices, it may refine services. I suppose it depends on the competitive situation in the location.

I don't think you can generalize. Obviously some of it would flow through the bank stockholders in some situations.

The Chairman. I am not indicating it would be necessarily bad for the banks to increase their profits. I think bank profitability has been too low. I think it would be desirable, certainly, to increase bank capital. But I just would like to know if you have a judgment on that.

The Federal Reserve bill would require that nonmember reserves be held in Federal Reserve banks, member banks, or Federal home loan banks. Presumably the member banks receiving the reserves would already be correspondents of the nonmembers. There are many nonmembers that act as correspondent for other nonmembers. Do you see any problem in having nonmember banks receive the reserves of other nonmembers on the same passthrough basis as members?

Mr. Carswell. I don't know what technical problems of identification that would raise. I suppose you would have to have an exemption similar to the one that the Federal Reserve has in its bill now that says that the member bank receiving a nonmember correspondent's reserves must pass through the balances for Federal Reserve Bank, but is not required to hold reserves against the balances or include the balances when computing its Federal deposit insurance assessment.

I assume you would have to have a technical amendment to take care of that situation. But it could be done that way.

The Chairman. Now the Federal Reserve has a surplus of $1.1 billion. It is proposed to transfer about half of this in the first 3 years of this operation to alleviate the effect on the Treasury, or to cancel it.

I don't understand why they have to have a surplus.

Chairman Miller's response to that was if it is a bank you have to have a surplus. But it is not a bank, they have no liquidity problem, no safety and soundness problem. Why shouldn't that be given to the Treasury to reduce the deficit?

Mr. Carswell. I read yesterday in the newspaper that you had asked him that question, and had not received a comprehensive response. So I looked into it as best I could yesterday afternoon. I must say that the history of the surplus appears to go back some way, and I wasn't able to resolve the question of why it shouldn't be transferred to Treasury.

The policy which the Fed has followed since at least 1960, appears to be to maintain a surplus at the same level as the paid in capital stock that it receives from member banks. That amount now is a little over $1 billion.

The Chairman. Now they propose to cut that in half by giving it to the Treasury to make it easier to pay interest on reserves. Apparently that doesn't phase them. Shouldn't we wipe out the whole thing, whether they pay interest on reserves or not?

Mr. Carswell. I wish I were clearer as to what the original reason was for that surplus. I don't think it has any particular effect on the U.S. Government, in the sense that it is circular. The Fed, I assume, simply invests that surplus in U.S. Government securities. If the
money were transferred to the Treasury, it would simply reduce the
debt and we wouldn't sell those securities. So in that sense it is circular.
There are a number of budgetary and accounting questions in this.
I assume the Fed holds the surplus because it has some reason to
think that there may be contingencies that it might face one day, where
it would have to reach into that surplus, such as foreign currency
swaps that went wrong, or whatever, but I just don't know.

The CHAIRMAN. Nobody can seem to come up with any reason why
they should have it.

Mr. CARSWELL. It has not been used, as far as we can tell, since the
early 1960's. But again it is not a matter of great moment in the sense
that it is circular. It is not lowering the revenue of the U.S. Govern­
ment as such, because, as I say, the amounts involved are still invested
to the benefit of the Treasury.

The CHAIRMAN. Senator Sarbanes.

Senator SARBANES. Thank you, Mr. Chairman. Mr. Carswell, I guess
the underlying problem we are trying to get at is a sufficient number
of banks should remain within the order or influence of the Federal
Reserve so it can carry on monetary policy. Isn't that the basic
problem?

Mr. CARSWELL. Yes, sir.

Senator SARBANES. Now, isn't that problem analytically separate
from the question of payments to the bank to be members of the
System?

Mr. CARSWELL. Yes; I think it is analytically separate. As I said to
the chairman, it has unfortunately become tied to the membership
question. We have linked membership with other aspects of our bank­
ing system such as regulatory matters. But the problems of a central
bank with respect to reserves and monetary policy are clearly separa­
rable analytically from membership. To deal specifically with the mon­
etary policy issue would require moving to a system of universal re­
serve requirements whether or not an institution is a member.

Senator SARBANES. Until you do that, you haven't really solved the
problem?

Mr. CARSWELL. I think that is correct. The ultimate solution to the
problem is to do that. That is why we prefer that approach.

Senator SARBANES. Is there any central bank in any other developed
country that permits its banks to take themselves out from under the
influence of the monetary policy set by the central bank?

Mr. CARSWELL. I have been told by the Fed staff that the answer to
that is no, there are none. We have not done an independent survey of
central bank requirements.

Senator SARBANES. If you start figuring out ways to, in effect, pay
them for being members, in order to keep them under the system, then
first of all you have no guarantee that that will keep enough of them
in to make the monetary policy work. I mean that is the problem you
are concerned about now?

Mr. CARSWELL. I think that is right.

Senator SARBANES. Is the Treasury more concerned about that prob­
lem, or the loss of revenue?

Mr. CARSWELL. I don't know that I can rank them. I think the
Treasury has two concerns. One is that we have a central bank in this
country that is strong enough to conduct adequate monetary policy
in the country. Our second concern is revenue loss. The potential
revenue loss involved in solving the membership problem may, as the chairman pointed out, be significant.

It does raise questions, I suppose, as to whether that has been considered in a discrete way by the Congress. I don't know that there is any necessary inequity involved in our efforts to minimize the payments to the banks because as the chairman points out, banking is a separate and unique kind of industry. The fact that banks are allowed to use other people's money has meant that they have always been regulated by the Government. Therefore, the fact that banks should have to pay for that privilege by maintaining reserves at the Federal Reserve isn't necessarily equitable.

Senator SARBANES. For a properly functioning monetary system with a central bank that can have an overall developed monetary policy, that is the central framework for an individual bank really to be able to operate. It would seem to me there is a strong rationale for requiring the individual bank to be under the orbit of the central bank. Otherwise you are not going to have a functioning monetary system.

Mr. CARSWELL. I agree.

Senator SARBANES. Is the run on membership and the number escaping the system now severe enough that you think the impact on monetary policy has been weakened in a significant way?

Mr. CARSWELL. I think, to be candid, it hasn't happened yet. I think one can overstate this problem in the sense that monetary policy today is conducted primarily through open market operations, and that is not analytically linked to membership.

On the other hand, there are problems with a monetary system that isn't really able to use reserve requirements as a tool of monetary policy, because it exacerbates the membership problem. What we have done, really, is to deprive the central bank of an array of tools it probably should be using or considering using in some instances, but which are not now available. On the other hand, we are getting by certainly with a monetary policy that is adequate.

But at some point, when the members leave in sufficient numbers, you will really have deprived the central bank of, I think, the kind of influence it ought to have in a properly functioning system.

Senator SARBANES. Thank you.

The CHAIRMAN. On that last point, I think Mr. Carswell made it clear that his preferred solution was universal reserve requirements. In that event, you don't have to worry about the membership problem as far as monetary policy is concerned. If you impose universal reserve requirements across the board, that is. You have a completely effective monetary policy as far as that particular instrument is concerned, right?

Mr. CARSWELL. Yes.

The CHAIRMAN. Thank you very much, Mr. Carswell. We appreciate very much your testimony.

Next we have a panel of three witnesses: John G. Heimann, Comptroller of the Currency; Carol S. Greenwald, commissioner of banks in Massachusetts; and Richard S. Ravenscroft, president of the Philadelphia National Corp.

Mr. Heimann, we are honored and happy to have you here. We hope you can confine your oral testimony to 10 minutes or so. We will ask the other witnesses to do likewise, so we have as much time as possible for questions.
Mr. Heimann. Thank you very much, Mr. Chairman. I have submitted testimony for the record, and this will be a brief summation.

I am honored to be here and pleased to be sharing the table with the commissioner from Massachusetts.

I welcome this opportunity to present the views of our office on attrition of banks from the Federal Reserve System and proposals to deal with that problem.

The recent upsurge in conversions of national banks to State nonmembers reflects the financial burden and increasing unfairness built into the present system of Federal Reserve membership.

In times of low interest rates and high profits, institutions can ignore this burden. In today's inflationary and highly competitive environment, many institutions cannot. If not corrected, the current trend may have serious implications for our financial system and the governmental framework designed to insure its stability.

Accordingly, we view the proposals offered by the Federal Reserve Board, S. 3304, and other similar proposals offered in the House of Representatives, to be timely and constructive. In fashioning a solution to the attrition problem, we should seek to modify the existing framework in a manner that will facilitate greater reliance on the market, and less reliance on governmental decisions or restrictions.

In my judgment the broad outlines of the framework in which we should work include reserve requirements which fall equally upon comparable liabilities for all deposit-taking institutions, the receipt of a rate of return appropriate under the circumstances on these reserve balances, explicit pricing of Federal Reserve and correspondent services, open access to these services for all institutions which maintain reserves, and payment of interest on demand balances.

At least three approaches to restructuring the reserve requirements have been proposed. These include the imposition of at least some reserve requirements on nonmember institutions, the payments of interest on required reserves or permitting member banks to hold reserves as interest-bearing instruments, and the lowering of reserve requirements.

Any one or a combination of these might solve the problem of membership attrition.

In assessing various proposals, it seems to me certain considerations should govern our action. We ought to seek a solution which most likely will, (1) achieve substantial equity among competitors of comparable size and character, whether they be State or nationally chartered, members or nonmembers, thrifts, credit unions or commercial banks.

(2) Maximize the efficiency and effectiveness of our control of monetary policy in the long run.

(3) Minimize the cost to the Treasury and hence most importantly to the taxpayer.

(4) Restore the balance between the State and national banking system.

(5) Minimize the difficulty of administering the system in a manner to maintain equilibrium. And finally, (6) be most consistent with
long-run changes which will insure a more efficient financial system which places maximum reliance on pricing and on competition, rather than on governmental intervention.

We believe that the imposition of reserve requirements on member and nonmember institutions represents the strategy for deterring withdrawal from system membership most nearly consistent with these six principles, and this approach should be adopted by the Congress.

Some have expressed the concern that this strategy would undermine the viability of the dual banking system. In response, and lest anyone think this judgment reflects a parochial point of view as the supervisor of the national banking system, I would like to quote from my own testimony before another congressional committee in 1976.

There are those who fear that a system of mandatory reserves established by the Federal Reserve would be the death knell of the dual banking system. I reject that notion. Moreover, from a public policy view, there is no advantage to a State system which survives because it offers the regulated institutions a bargain in reserve requirements.

As State regulators—

I might point out, Senator, that at the time I was a State supervisor making this statement—

we should be ready to compete with the Federal bank regulatory system by offering high quality examination and supervision, speedy and even-handed handling of branch merger, chartering and acquisition applications, and a progressive statutory and regulatory framework within which banking organizations can compete.

My position today as Comptroller of the Currency is consistent with my position as a State supervisor of banks. I am, of course, prepared to address the issues raised by each of these proposals now before the Congress, and have done so in our prepared testimony.

However, I would like to note a few specific points at this time.

First of all, it should be noted as a matter of fairness, reserve requirements should be imposed equally upon all depositing institutions which compete with one another. The case is especially strong with respect to transaction accounts. However, although we support the extension of reserve requirements to all institutions, we do not believe that the actions to address the attrition problem should necessarily await the imposition of federally mandated reserve requirements upon institutions other than commercial banks, which have heretofore not been subject to such reserve requirements.

Second, we believe that the Federal Reserve System should move as quickly as possible to provide its services, and we favor open access to Federal Reserve services for all nonmembers, at nondiscriminatory prices.

Third, the payment of market rates of interest on required reserves should be linked to both the phasing-in of Federal Reserve pricing and the elimination of the prohibition of the payment of interest on interbank demand balances.

Finally, we support legislation which expands the authority of the Federal Reserve Board to require information to assist in the conduct of monetary policy.

Thank you.

[The complete statement of Mr. Heimann follows:]
STATEMENT OF JOHN G. HEIMANN, COMPTROLLER OF THE CURRENCY

Mr. Chairman and members of the Committee: I welcome the opportunity to present the views of our Office on attrition of banks from the Federal Reserve System and proposals to deal with that problem. The recent upsurge in conversions of national banks to state nonmembers reflects the financial burden and increasing unfairness built into Federal Reserve System membership. In times of low interest rates and high profits, institutions can ignore this burden. In today's inflationary and highly competitive environment, many institutions cannot. If not corrected, the current trend may have serious implications for our financial system and the governmental framework designed to assure its stability. Accordingly, we view the proposals offered by the Federal Reserve Board, S. 3304, and other similar proposals offered in the House of Representatives, to be timely and constructive.

ATTRITION FROM THE FEDERAL RESERVE SYSTEM AND THE NATIONAL BANKING SYSTEM

The Federal Reserve System has experienced a gradual decline in membership since World War II. In recent years, that trend has accelerated. The percentage of total deposits of commercial banks held by Federal Reserve members has decreased from approximately 80 percent in 1970 to approximately 73 percent at present. During this period, there has been a net loss of 327 member banks through conversion. Since the beginning of 1977, 108 banks have withdrawn, including 39 during the first half of this year. More disturbing than the numbers themselves is the increased willingness of larger institutions to leave the System. Historically, banks withdrawing from the System have almost always held fewer than $50 million in deposits. In 1977, 15 of 69 converting banks held deposits amounting to more than $100 million.

During the 1960's only once did the national banking system experience withdrawal of more than 20 banks in a year. Since 1970, only once has this figure dipped below 20. In 1977, 44 national banks withdrew and 24 have withdrawn so far this year. Withdrawing national banks have accounted for more than 50 percent of the total deposits lost by the Federal Reserve System in five of the last eight years.

There is some evidence that these figures would be significantly larger but for the willingness of a number of banks to await the results of these current efforts to address the root cause of attrition from the System.

THE CAUSE OF MEMBERSHIP ATTRITION

The conversion of banks from national to state charters and vice versa is not new. The phenomenon is characteristic of our dual banking system. The reasons for individual conversions have been as varied as the corporate strategies one would expect in a diverse banking system. Although objection can be raised to the motivation to convert in a given case, on balance, the possibility of conversion has been a source of the system's vitality and has provided pressure for progressive reform.

The Comptrollership of James Saxon is illustrative. His liberal attitudes toward entry, branching and the powers of national banks greatly enhanced the attractiveness of a national bank charter. While many state banks were placed at somewhat of a disadvantage, the imbalance between the two systems was soon corrected. As a result of action on the national level, many states revised their laws and policies. Although Mr. Saxon's tenure was replaced by a more cautious period in the Comptroller's Office, most observers believe that the balance which was struck was a significantly more dynamic and innovative system.

A different factor has created the current disequilibrium. Its cause is not obscure. No one seriously challenges the proposition that the current increase in System withdrawals flows primarily from the fact that the cost of maintaining sterile reserves outweighs the benefits of membership for the vast majority of institutions. As a result, there is a profound bottom line incentive for banks with certain characteristics to leave the Federal Reserve System.

As I have suggested, the impact of the disparity of cost and benefits is amplified by our inflationary economy, as well as by increased competition from nonmember banks and other deposit-taking institutions. This is demonstrated dramatically in the New England states, where introduction of NOW accounts and broadening thrift powers have greatly increased competition. As a result, the share of deposits held by member banks in New England has fallen from 73 percent at the end of 1974 to less than 62 percent at the end of 1977.
THE IMPACT OF A FAILURE TO ADDRESS THE PROBLEM

Failure to redress the inequitable burden of System membership in some fashion will, in all likelihood, lead to further acceleration in the rate of withdrawals from membership. Included among these may be a significant number of relatively large, complex institutions.

While I would not speculate at what level of withdrawal we would begin to see serious consequences, I do fear that the increased rate of withdrawal from membership which is likely will erode the role of the Federal Reserve as central bank and eventually result in serious adverse consequences for the national banking system. The reasons for this concern are several.

UNFAIRNESS TO MEMBER BANKS

In my judgment, the most persuasive argument for reform is the substantial inequity built into the existing structure of reserve requirements, exacerbated by periods of inflation and high interest rates. For either a national bank or a state member bank which does not obtain benefits (in the form of Federal Reserve services or profits from a correspondent banking relationship) adequate to compensate it fairly for maintaining reserve balances, the difference between the benefits actually received and a fair return on services constitutes a tax upon the institution. The Federal Reserve System has estimated the aggregate burden of membership to be on the order of $650 million, a tax that is borne ultimately by customers and/or shareholders of member banks. There is a significant competitive disadvantage when nonmember banks operate free of this tax.

The inequity is compounded by the fact that the burden may not fall evenly, even among member banks. According to Federal Reserve Board staff, the relative burden of membership is greatest for small banks. That burden is estimated to exceed 20 percent of profit for banks with less than $10 million in deposits. Thus, those institutions that make the least use of Federal Reserve services must bear the tax most heavily.

IMPACT ON THE NATIONAL BANKING SYSTEM

Congress, for more than a century, has continued to support a dual federal/state system of commercial banking. The vitality, competitiveness and innovativeness of our banking system bear witness to the wisdom of this approach. An important principle underlying this policy has been that, over time, a rough competitive balance should be maintained between the two systems. This balance, or equilibrium, is necessary to maintain the viability of state banking systems and it is essential to insure the appropriate role of federal policy in the banking system. Congress has recognized that a viable system of federal chartering is a key to the government's authority over a major portion of the banking system. This authority has been important from the perspective of statutory limitations and incentives to promote a sound, competitive and progressive banking structure.

With this perspective, it is particularly ironic that institutions with certain characteristics are now being given a significant incentive to convert from a national charter to state charter by the federal government itself. To the degree that significant numbers of banks leave the national system for state nonmember status, the impact of federal law and policy on the banking system is necessarily diminished. In short, the inequitable impact of reserve requirements is serving to undermine the purposes of the National Bank Act and to lessen the role of Congressionally defined standards of conduct, prudence and diversification in the nation's financial system.

In addition to lessening the impact of the National Bank Act and other legislation applicable to national banks and other member institutions generally, the incremental effect of inequitable reserve requirements seems most likely to discourage small institutions from seeking or retaining national charters. Although some have argued that the Comptroller of the Currency should be the regulator of large banks, leaving the smaller institutions to the states, I would find that result singularly unfortunate. My experience as Superintendent of Banks in New York State underscored for me the importance of a supervisor having jurisdiction over a balanced range of different types and sizes of institutions. This is necessary to maintain an appropriate understanding of the banking system and may, from time to time, be instruments of federal policy, it is important that institutions of all sizes have a place in the system.
POTENTIAL IMPACT ON SUPERVISION AND REGULATION

While conversions from the national banking system to date have not seriously interfered with our ability to supervise and regulate banks, or threatened the soundness of any individual bank, I believe that if this trend continues and accelerates, it will have an adverse impact on our supervisory capacity. The sources of this concern are several.

The first arises out of problems associated with the transition which occurs as a bank converts from primary supervision by the Comptroller's Office to primary supervision by a state authority. The supervision of a large financial institution is a complex task. Critical to performing that task effectively is the thorough knowledge of the bank's personnel, policies and history. The new examination procedures recently adopted by the Comptroller of the Currency emphasize these factors.

To the degree that this understanding of the institution is an important aspect of supervision and regulation, the efficiency and effectiveness of supervision are damaged when a bank changes from one system to another. We view this slippage as a price paid for the maintenance of a vital dual system, and needless to say, we make every effort to minimize it through effective communication and coordination among regulators.

Thus far, no major supervisory lapses have come to my attention as a result of such a conversion. Nevertheless, the shift does place a strain on the supervisory framework and consumes extra resources. Were the level of conversions to increase substantially and were those conversions to include a substantial number of large institutions, it would surely have a significant impact on the efficiency and effectiveness of our supervisory and regulatory efforts.

Second, to the degree that shifts occur from national to state charters, a commercial bank is leaving a framework of regulation which, in the aftermath of the failures of U.S. National Bank and Franklin National Bank, has made enormous strides in modernizing its approaches and policies to deal with large, complex financial institutions. The process continues as we move in the coming months to establish a multinational division which will focus specifically on the problem of large national banks. Here again, significantly increased attrition, especially among large banks, appears likely to lead, at least in the short-run, to a loss of efficiency and effectiveness in supervision and regulation.

IMPACT ON MONETARY POLICY

The principal concern of the Federal Reserve Board has been the impact of continued membership attrition on its ability to conduct monetary policy. Chairman Miller has stated that "(a)s 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." Three factors were cited by Chairman Miller in this regard, including the arguments: that availability of the discount window as a "safety valve," allowing individual banks to make adjustments during periods of restrictive action by the Federal Reserve, provides needed flexibility which is diminished by attrition; that attrition within the System weakens the link between bank reserves and the monetary aggregates, thereby blunting the precision with which monetary policy can be exercised; and that while reserve requirements historically have not been an membership consideration, especially during a period in which the efficacy of open market operations is diminished.

Historically, critics of the Federal Reserve's position have countered the Federal Reserve System's proposals for solution of the membership problem with the argument that neither reserve requirements nor membership is necessary for the effective conduct of monetary policy. They contend that open market operations are the principal tool of monetary policy, and the Federal Reserve Board does not need to maintain direct control over reserves, but only be assured of adequate data.

The debate over the years indicates that reasonable people are divided on the need for reserve requirements as a tool of monetary policy and the need for membership at all. It seems to me, however, that Chairman Miller placed his case in the proper perspective by arguing, not that attrition necessarily destroys the effectiveness of monetary policy, but that, as a practical matter, the current trend may have the negative impact of reducing the System's flexibility and precision.
Whether or not those who argue on the theoretical basis are ultimately correct, I believe that the Federal Reserve's pragmatic concerns should be given great deference.

In addition to the concerns I have outlined, two other factors seem relevant. Apart from debates as to the optimal structure from the point of view of monetary policy, the very state of flux resulting from continued and accelerating attrition may well complicate the conduct of monetary policy, since ongoing adjustments in tools of analysis and policy must be made to take into account the changing system. Moreover, there can be little doubt that concern with the membership problem is distracting and occupies valuable resources.

**PROPOSED SOLUTIONS**

The immediate task before us is to devise a strategy for restructuring reserve requirements which will correct the disequilibrium resulting from the inequitable burden of these requirements on some member institutions, thereby avoiding the consequences of continued and accelerated attrition from Federal Reserve membership. Addressing this task, we should keep foremost in mind a long-run objective: the evolution of a financial system which is as efficient and flexible as possible.

I am convinced that the most desirable financial system is one which relies to the maximum degree possible on the market mechanism as the allocator of resources. Of course, this is not our present system. The maintenance of sterile reserves; the prohibition of the payment of interest on demand deposits and other interest rate restrictions; the absence of explicit pricing of Federal Reserve and correspondent services; and limitations on which institutions can use these services; and limitations on which institutions can use these services represent interference with the market mechanism. As such, they are not necessarily bad; at times, governmental intervention in the marketplace is appropriate. At the same time, departures from a market system should be carefully examined and re-examined to see that they are warranted, that they do not lead to unintended consequences, and that they have not outlived their usefulness. The existing disequilibrium, in my judgment, arises out of a framework of governmental action and restrictions which has grown increasingly inappropriate.

Accordingly, in fashioning a short-run solution to the attrition problem, we should seek to modify the existing framework in a manner that will facilitate greater reliance on the market and less reliance on governmental decisions or restrictions. In my judgment, broad outlines of the framework which we should work toward include: reserve requirements which fall equally upon comparable liabilities for all deposit-taking institutions. In my judgment, broad outlines of the framework which we should work toward include reserve requirements which fall equally upon comparable liabilities for all deposit-taking institutions; the receipt of a rate of return appropriate under the circumstances on these reserve balances; explicit pricing of Federal Reserve and correspondent services; explicit pricing of Federal Reserve and correspondent services; open access to these services for all institutions which maintain reserves; and payment of interest on demand balances.

These changes cannot be implemented immediately or simultaneously. Even if it were possible to do so, it might not be desirable, since immediate imposition of such a revision would probably cause significant dislocations. Rather, a more measured approach is appropriate. At the same time, in the context of action to avoid the consequences of continued and accelerated attrition from the System, it is possible to take affirmative steps to move in the direction we have outlined.

At least three approaches to restructuring of reserve requirements have been proposed. These include: imposition of at least some reserve requirements on nonmember institutions; the payment of interest on required reserves or permitting member banks to hold reserves in interest-bearing instruments; and the lowering of reserve requirements. Any one or a combination of these might solve the problem of membership attrition.

In assessing various proposals, it seems to me that certain considerations should govern our actions. We ought to seek a solution which will be most likely to:

Achieve substantial equity among competitors of comparable size and characteristics, whether they be state or nationally chartered, members or nonmembers, or thrifts or commercial banks;
Maximize the efficiency and effectiveness of our control of monetary policy in the long-run;
Minimize the cost to the Treasury and hence the taxpayer;
Restore the balance between the state and national banking systems;
Minimize the difficulty of administering the system in a manner to maintain equilibrium; and finally,
Be most consistent with long-run changes which will insure a more efficient financial system which places maximum reliance on pricing and competition rather than governmental intervention.

We believe that the imposition of reserve requirements on member and non-member institutions represents the strategy for stemming withdrawal from System membership most nearly consistent with these principles and that this approach should be adopted by this Congress.

Extension of reserve requirements to nonmembers is the preferred solution for several reasons. First of all, the success of various proposals which have focused upon the payment of interest on reserves to stem attrition would be dependent on correct targeting of the benefits conferred. This would be difficult to administer and might require constant adjustments in order to achieve the desired effect. Second, precisely because targeting is required to stem attrition at a minimum cost, the payment of interest on reserves would almost certainly by itself fail to address the question of equity among comparable institutions. Third, universal reserve requirements could involve the least cost to Treasury and hence the taxpayers. Fourth, the imposition of some form of universal reserve requirements represents a step toward more effective control and flexibility over monetary policy—a step which might allow the Federal Reserve System to set reserve requirements at a relatively low level.

We have not attempted to address the specifics of various proposals in great detail. I am, of course, prepared to address the issues raised by each of the proposals now before the Congress. A few specific points should be noted.

As a matter of logic and fairness, reserve requirements should be imposed equally upon all deposit-taking institutions which compete with one another. The case is especially strong with respect to transactions account from the point of view of both monetary policy and equity. Since other deposit-taking institutions are increasingly in direct competition with commercial banks to provide this facility, it seems only fair that the burden of the tax-imposed by reserve requirements be shared by these institutions on an equitable basis. And, as other deposit-taking institutions increasingly provide transactions accounts, these balances may become important in the exercise of monetary policy. S. 3304 recognizes these points.

However, although we support the extension of reserve requirements to all institutions, we do not believe that action to address the attrition problem should necessarily precede the imposition of federally-mandated reserve requirements upon institutions other than commercial banks, which have heretofore not been subject to such reserve requirements. It is possible, for example, to conceive of several approaches which would involve a phasing-in of reserve requirements as other deposit-taking institutions come into more direct competition with commercial banks. One might, for example, key the imposition of reserve requirements to a rather high level of transactions accounts.

Second, we believe that the Federal Reserve System should move as quickly as possible to price its services, and we favor open access to Federal Reserve services for all nonmembers at nondiscriminatory prices. Although not opposed to legislation requiring pricing, we believe such legislation may not be necessary given the stated commitment of the Federal Reserve System to move to a system of explicit pricing. In any event, legislation requiring the Federal Reserve System to price its services should allow for the orderly introduction of such a system—recognizing the task of pricing services heretofore without charge will be difficult and that the transition period will necessarily require a complex series of adjustments on the part of many affected institutions and the financial markets.

Third, the payment of market rates of interest on required reserves should be linked to both the phasing-in of Federal Reserve System pricing and to elimination of the prohibition of the payment of interest on interbank demand balances. The linkage between Federal Reserve services and the earning of Interest on reserves, of course, arises because free services now provide a substitute for interest on these reserve balances. Thus, to the degree that banks are compensated for reserves, the services should no longer be provided without charge.
Similarly, correspondent banks now provide free services as compensation for balances. In order to maintain the viability of the correspondent system and to provide yardstick competition for the Federal Reserve System, correspondents should be allowed to pay interest on demand balances which are maintained with them.

Finally, we support legislation which expands the authority of the Federal Reserve Board to require information to assist it in the conduct of monetary policy. This provision is supported by scholars and practitioners of monetary policy, and deserves enactment.

In conclusion, I would reiterate two points. Attrition from the Federal Reserve System is a problem which deserves a solution now before it causes serious consequences and not after. In devising an immediate solution, we should seek measures which facilitate and encourage evolution of the banking system in a manner that involves greater reliance on the market mechanism and less reliance on government prescription. We look forward to working with the Committee and its staff in this effort.

Senator RIEGLE. [presiding]. Thank you, Mr. Heimann. We are delighted to have you here, it is a pleasure seeing you again.

Ms. Greenwald, do you want to proceed next? It is a pleasure to have you back here.

STATEMENT OF CAROL S. GREENWALD, COMMISSIONER OF BANKS, COMMONWEALTH OF MASSACHUSETTS

Ms. GREENWALD. I welcome this opportunity to review and comment on the appropriate role of the Federal Reserve System. It is quite clear the U.S. economy needs a central bank which can devote its attention to monetary policy and to preventing a liquidity crisis.

Although I have heard several comments this morning that tie membership in the Federal Reserve with the ability of the Fed to conduct monetary policy, as an economist I believe that is not true. However, I support legislation to allow the Fed to set universal reserve requirements in the context of universal non-membership in the Federal Reserve System, because I do believe worrying about membership has kept the Fed from spending all of its time which it desperately needs to devote to monetary policy. In that sense it diverts the attention of the Board from important problems. Does membership at all impact on monetary policy? Let me explain what I mean by universal reserve requirements in a system of universal non-membership. I have no problem as a State regulator with having the Fed set reserve requirements for banks. In fact, right now the State Reserve requirements are approximately at the same level as the Federal Reserve requirements on transaction accounts.

If instead there has to be some compromise made with the dual banking system and we have to leave the Fed setting reserve requirements only for federally chartered institutions, then we are left with disadvantage of having to pay interest on required reserves. It is a very
costly solution, and you would have attrition of Fed membership because of the cost of belonging to the system, unless the Fed pays interest on reserves held at the Fed. I agree with the Chairman that eventually we will be paying interest at market rates, that will be the only way to keep the members.

If the States allow reserves to be held in Treasury bills and market bearing Government securities, to keep it competitive, you would have to pay market rates of interest. That is a very big tax cut to give the largest banks in this country.

I find it very difficult to think the Congress deliberated and came up with the conclusion that the group most in need of a tax cut at this time is the large banks.

My major problem with the Fed’s proposal as opposed to my alternative for universal nonmembership is that their proposal is really a plan not only for universal reserve requirements, but for universal membership. The way they have it set up, they will equalize the burden among all financial institutions, but they won’t quite equalize all of the benefits. You must remember only members are going to have access to the discount window. Everybody has the same burdens, but only members have access to the discount window. So obviously it is only sensible to end up being a member.

Although the Fed has said that universal reserve setting authority has no regulatory aspects, that is not quite true, because it logically leads to the universal membership.

I have testified on other occasions before this committee in favor of the Federal Bank Commission, and I still believe you want to separate bank supervision and the central bank authority. What we would have now if we go along with the Fed’s proposal is we will have made the Federal Reserve the heir apparent to the Federal Bank Commission, because it will be the only Federal regulatory authority which will have regulatory control over all kinds of financial institutions.

And while I think it is right to centralize supervision, I think we should debate at this point whether we really want to merge the Federal Bank Commission into the Federal Reserve System.

It seems to me regardless of what we do with reserves, we really want to answer the question of access to the discount window. It would be absurd to say that the central bank is only willing to come to the aid of a bank in terms of a liquidity crisis if it is a member of the Federal Reserve. We have managed to debase our central bank to the level of a private club or trade association. That is certainly absurd. If you want to make sure that banks only use the discount window when they have liquidity problems, you could tie the discount rate at a quarter of a point above the Federal funds or Treasury bill rate. Proposals to make the discount rate a penalty rate have been around for a long time. It could be enacted as part of the proposal for opening up access to the discount window to all banks.

As I have said previously, paying interest on reserves is no longer needed when you go to the universal reserve requirement, and since going to the universal reserve requirement has the advantage of not costing the Treasury and the U.S. taxpayers any money, plus it has the advantage of ending the Federal Reserve wasting its time thinking about members, I would endorse and highly recommend that the
Congress move toward the Federal Reserve having the authority to set universal reserves in the context of universal nonmembership, so that the Fed can be reoriented to being the central bank.

Finally, just to comment on Chairman Reuss’ plan, I think it is an excellent plan. It has only, I think, three minor disadvantages. One is you still have the membership problem for banks with under $100 million in reserve liabilities and it won’t solve access to the discount window for those banks who are outside of the Fed, and you could have a liquidity problem and a crisis created when some of those banks needed funds.

Also the Chairman’s proposal does not include NOW accounts, and when we go to national NOW accounts, we would have to change his definition of transaction account to include those thrift institutions that would have the NOW accounts.

Finally, we are left with a situation of a central bank with members and the central bank still worrying about its political position and its constituency.

So I think the preferred way to go is universal reserve requirements and take them out of the supervision business entirely.

Thank you.

[The complete statement of Carol S. Greenwald, Commissioner of Banks, follows:]

STATEMENT OF CAROL S. GREENWALD, MASSACHUSETTS COMMISSIONER OF BANKS

I welcome this opportunity to review and comment on the appropriate role of the Federal Reserve System. The U.S. economy needs a central bank which can devote its attention to monetary policy and to preventing liquidity crises. This can best be accomplished if the Federal Reserve had no occasion to waste its time worrying about a membership problem. The obvious solution is to abolish membership, to give every bank access to the discount window and to Federal Reserve services at full cost and to allow the Fed to set required reserves.

The Fed’s plan for universal reserve requirements is really a plan for universal membership. To separate bureaucratic ambition from allegedly needed monetary policy controls, the Fed should be given broader reserve setting authority, but should give up the concept of membership and withdraw from the bank supervision area. This is a proposal for universal non-membership in a purified central bank. The other side of the universal reserve setting authority should be universal non-membership.

Whether the Fed sets the level of required reserves for all depository institutions with transaction accounts or just for federally-chartered institutions does not appear to be crucial for monetary policy. The symmetry of the dual banking system would be preserved if the Fed set required reserve levels just for federally-chartered institutions. Doing this in combination with legal authority to collect asset and liability data from state-chartered institutions would amply meet monetary policy needs. Required reserve levels are about the same whether set by the Federal Reserve or the states, since they are set by what is considered prudent liquidity requirements. The main difference is in the composition of the reserves, not in the levels. The proposals to allow the Fed to pay interest on reserves would remove an important element of difference.

The disadvantages of not having the Federal Reserve set universal reserve requirements are two:

First, federal reserve requirements could be higher than some state requirements leaving a minor competitive disadvantage to federally-chartered institutions. But this is no way would be anything like the present disadvantage suffered by members versus non-members. In fact, the relative burdens are likely to be very much the same if federally-chartered institutions are paid the Treasury bill rate.
on reserves. Second, if the Fed in fact did decide at some point in the future to
revive changing reserve requirements as a monetary tool, the effectiveness of this
tool would be diluted somewhat by its limitation to federally-chartered institu­tions.
The diluting effect would not be great, however, and, in fact, this is almost a
purely theoretical consideration since the Fed has used changing reserve require­ments as a monetary tool so rarely. It has not been used because it is considered a
sledgehammer approach; and there are much more flexible instruments avail­able, i.e., open market operations. Open market operations have been the operat­ing tool of monetary policy and its effectiveness is not affected by whether state law or
the Federal Reserve has set a given level of reserve requirements.

The major disadvantage of the Fed plan is that it is really a plan for universal membership. The proposal would allow it to set reserves for all institutions, pay the
same rate of interest on those reserves, and to offer all services but the discount
window to all banks at the same rate. Since the burdens are the same for mem­bers and non-members, but only members get access to the discount window, it
would only make sense in this setting to be a member. The Fed has said that uni­versal reserve setting authority has no regulatory or supervisory aspect. That may
be true unless you look to see that it logically leads to universal membership.
And thus the Fed will be the logical heir apparent to become the Federal Bank
Commission, for only the Fed would then have federal regulatory responsibility
for all depository institutions.

We have previously testified that a unified federal bank supervisory agency is a
good idea. We argued, however, that this function should be separate from the
agency dealing with monetary policy. A plan for universal non-membership with
access to the discount window and Fed services for all depository institutions has
really the same long-run effects as the Fed's plan, only without the self-aggrandizement of the latter. Our proposal here for universal non-membership
would help create a pure central bank, i.e. one with responsibility for monetary
policy and a lender of last resort. These are the essential functions of a central
bank. The Fed's proposal for universal membership is one in which it would end
up as the superbanking agency, i.e. central bank and federal bank commission
combined. This degree of centralization may or may not be desirable, but it should
be debated now.

Regardless of who sets reserve requirements, the absurdity of access to the
discount window being limited to members must be dealt with. The Fed was
created as a result of a liquidity crisis to be a lender of last resort before anyone
ever thought of discretionary monetary policy. To limit the discount window to
members is to debase the central bank to the level of a trade association or private
club. We are proposing universal access to the discount window by all depository
institutions. To ensure that the borrowing is used judiciously, the discount rate would be
set above the federal funds rate or the Treasury bill rate.

Paying interest on reserves is not an essential feature of a universal non-mem­bership system in which the central bank sets universal reserve requirements.
The Fed originally proposed paying interest on reserves to solve a membership
problem, which is no longer a problem in a non-membership system. It would make
sense to let the Fed pay interest on reserves if the Fed only set reserve require­ments for federally-chartered institutions because the states let state-chartered
banks hold reserves in government securities.

Paying interest on reserves is a tax cut for banks especially the largest and a
transfer to them of substantial proportion. To make more sense of this large tax
cut for banks, it should be shared with the public by lifting the prohibition of pay­
ing interest on demand deposits. Last year, this is just what the Fed proposed—
acquiring national NOW account availability to the Fed paying interest on reserves.

It was previously argued that not all the benefits of the tax cut would go to the
public even with NOW accounts, but some would have and now we have lost even
that much. I would find it hard to believe that the Congress has determined that
the largest banks are the elements in our society most in need of a tax cut.

I am tired of hearing about the Fed's membership "problem". You may be tired
of it too, as the American public and the media are tired and confused by this ob­
scure issue which, incredibly, is the number one priority of the distinguished new
chairman of the Federal Reserve System. The Fed's proposal, in its latest version,
is obscure to the public and laden with complex provisions only because it is de­
signed principally to solve the membership problem. Cutting to the core of the
plan, I find merit in its basic reserve-setting component and would recommend
statutory changes to provide this authority to the Fed in the context of universal
non-membership and reorientation of the Fed's activities to focus on its essential
responsibilities as the central bank.
ADDENDUM

The House Banking, Finance, and Urban Affairs Committee’s recently proposed plan to solve the Fed membership “problem” is clearly superior to the three alternatives previously presented. It is a very good plan.

I would only note three minor disadvantages of this plan as compared to universal reserve setting on transaction accounts by the Fed in a system of universal nonmembership:

1. It will not solve the membership problem for banks with under $100 million in reserve liabilities which will continue to have an economic incentive for leaving the system. The continued erosion of these banks could well precipitate a crisis if access to the discount window continued to be limited to members.

2. When national NOW accounts are authorized, it will be necessary to change the definition of reserve liabilities presently proposed to include all transaction accounts at both commercial banks and thrifts.

3. The basic anomaly of having a central bank with members will remain and the Fed still waste time worrying about its constituency and be heavily involved in regulatory matters rather than focusing attention more clearly on its essential central bank responsibilities.

Senator Riegle. Thank you, Ms. Greenwald. Mr. Ravenscroft, we know you come as an advocate of this approach, so we will be interested in hearing from you.

STATEMENT OF RICHARD S. RAVENSCROFT, PRESIDENT, ACCOMPANIED BY GEORGE D. NORTON, EXECUTIVE VICE PRESIDENT AND CASHIER, PHILADELPHIA NATIONAL CORP.

Mr. Ravenscroft. Thank you, Mr. Chairman. I am Richard S. Ravenscroft, president of the Philadelphia National Corp., a one-bank holding company, whose principal subsidiary is the Philadelphia National Bank.

Philadelphia National is the 28th largest U.S. commercial bank based on deposits, with a full range of consumer and commercial banking business, including an extensive correspondent banking business focused on clearing and payment services.

The corporation’s other subsidiaries operate in the areas of mortgage banking, consumer and commercial finance, Government securities trading and investment advisory services and come within the supervisory jurisdiction of the Federal Reserve System.

We want to thank you for the invitation to present our views here today on S. 3304, the Federal Reserve Requirements Act of 1978.

We favor the legislation because it would improve, in our views, the determination and execution of monetary policy, the soundness of the banking system, and the efficiency of our national payments system.

Further, it would end the abuse of the Federal Reserve’s operating services to fight the problem of membership attrition, which works to the detriment of private competition and initiative.

We are a member of the Third Federal Reserve District. Within our district we have seen 23 banks withdraw from the system from the end of 1970 to the beginning of this year. More have left this year, and still more appear on the brink of leaving, especially in the present climate of high inflation and interest rates. This experience parallels the nationwide trend reported by Chairman Miller in his recent testimony.
We are deeply concerned with the implications of this decline in the proportion of bank deposits subject to reserve requirements as it relates to the process of establishing and carrying out monetary policy. This trend also restricts banks' access to the resources of the Nation's lender of last resort during periods of severe economic stress. From our perspective of close day-to-day involvement with the Federal Reserve System, it is clear that the environment in which we operate has changed considerably as the Federal Reserve's membership problem has deepened and the Federal Reserve in turn has used every available mechanism in an unsuccessful effort to respond.

The first and perhaps most controversial of the proposals in S. 3304 would require the establishment of reserve balances at the Federal Reserve for all transaction accounts in depository institutions. By defining transaction accounts to include such services as negotiable order of withdrawal or NOW accounts in thrift institutions and share draft accounts in credit unions, this would extend reserve requirements not only to all but the smallest member and nonmember banks, but also to certain deposits in other financial institutions.

There is strong logic to this provision. It would improve control over monetary growth by bringing more of the basic money supply under the Federal Reserve's direct influence. It would also provide more uniform governmental treatment of deposits which perform basically similar economic functions.

On the other hand, we recognize very practical problems with passage of legislation bearing this provision and would recommend its exclusion, if necessary, so as to not protract debate.

In the longer view, we see issues of regulatory supervision and System membership as directly related to the major structural and technological changes which have reshaped our financial system and institutions. Today, commercial banks, like ourselves, compete for sources of funds and for earning assets with a host of other institutions, thrifts, credit unions, foreign banks, some insurance companies and brokerage houses, the commercial paper and capital markets, and the financial services units of major commercial and retail companies.

So much for the monopoly of the banking industry. In view of the urgency of correcting the membership problem, we feel that the issue of evenhanded treatment of all types of financial institutions offering financial services should be set aside, but we do note that the costs, restrictions, and inflexibilities of membership lie upon those commercial banks, small, medium, and large, who have remained within the System.

The most effective incentive to retain and build membership in the Federal Reserve System lies in the payment of interest on reserve balances. We oppose as discriminatory any proposal to limit the rate of interest paid on reserve balances over $25 million, or any other arbitrary amount.

We are aware that there are other ways to reduce the burden of membership, for example, by reduction of reserve levels, or by provision for holding some fixed portion of reserves in the form of Government securities. However, the payment of interest on reserves seems to us to be the most straightforward and simple approach, and
the one least encrusted with side issues related to the Federal Reserve's monetary role.

The reserve requirement associated with Federal Reserve membership is in effect a special tax on member banks, or, more precisely, a levy based upon the sum of deposits placed in those banks by individual customers.

Chairman Miller recently estimated the current level of that tax as $650 million a year; we believe that is a most conservative estimate. We recognize the concern of the Treasury about the impact of this proposal on its revenues, particularly as it faces the prospect of financing budget deficits of truly heroic dimension.

In turn, the Treasury should recognize that without prompt, decisive relief, membership will continue to erode, probably at an accelerated rate.

In turn, reserve balances held by the Federal Reserve will decline, and with them the Treasury’s revenues.

Chairman Miller has estimated that these losses will grow by at least $80 million for every year there is no relief. If membership were made attractive again, the reverse sequence could be expected. On balance, it is misleading to characterize interest payments as a “raid on the Treasury.” To paraphrase one of the more prominent citizens of our town, such a view simply is penny-wise and pound-foolish.

The effect of the tax represented by the reserve requirement becomes almost diabolical as member banks are forced by competitive pressures and economic reality to move toward paying interest even on customers’ transaction balances, as they have been for more than a decade on temporarily idle balances.

It also has an effect on the lending side. It seems curious that to achieve the same effective margin on a loan to a commercial borrower, U.S. commercial banks must charge roughly a half percent higher interest than that charged by a foreign bank or a nonregulated competitor and that all of the markup flows through our coffers into those of the U.S. Treasury.

It is in this context that I view comments that interest payments on mandated reserves represent a gift to the largest banks. It should come as no surprise that the largest banks receive the largest sums on their reserves; they have more customers providing more deposits upon which those reserves are based, and those idle sums currently provide the largest share of the revenues turned over to the Treasury.

There is nothing illogical or unfair about returning interest payments to all banks, regardless of size, in proportion to the amount of earning opportunities they are forced to forego by maintaining sterile reserves at the Federal Reserve.

I don’t see that any useful purpose is served by punitive or discriminatory provisions aimed at the 10 largest banks, or the 50 largest. Our banking system is based on a diversity of institutions. We need our large banks, which provide a breadth and sophistication of services the small ones cannot, as well as our small banks, which provide more convenient, often more personal services and attention.

A bank becomes and remains large because individuals and businesses make a cumulative set of explicit decisions to place their deposits with that institution. It is an observable fact, however, to which
the committee chairman alluded earlier, that many of our largest banks are not adequately profitable today, judged by the standards of business enterprise in general, the performance level of their banking peers, and the requisites of the capital markets. Because of domestic branching and line-of-business restrictions, the direct operations of many of the largest banks are confined to areas of declining economic vitality. Because of their central urban locations they probably face severe inflationary costs and growing local tax burdens. They have felt most directly competition from foreign banks not subject to the same reserve requirements and restrictions, as well as from other nonregulated markets and institutions providing commercial and consumer credit services.

Large banks bear a disproportionate share of the huge and still growing cost of Government regulation, reporting, and examination. They are already discriminated against in the progressive way in which the required reserve balance is calculated. Any additional discriminatory provisions would tend to worsen a situation which has already seen a number of major banks, weakened by these pressures, fall prey to foreign opportunists.

Those who have suffered most from these circumstances have been the shareholders who, by and large, are individuals or trusts and pension funds organized on behalf of individuals. About 80 percent of Philadelphia National’s stock is held by individuals or by fiduciary intermediaries on behalf of individuals, with the average individual holding less than $5,000 at current market value.

Across the nation, in small banks and large, bank earnings provide benefits of dividend income and capital appreciation to people of ordinary means.

We have stated our philosophical basis for supporting interest payments on reserve balances. In my view, these reasons are fortified by some very practical considerations which relate to the simultaneous unbundling and explicit pricing of the Federal Reserve’s operating services. Our bank will send about 200 million checks through the system this year, and thus faces substantial charges for such services. However, we strongly favor this approach. An equitably structured pricing system would permit private competition and innovation in payment services, fostering a truly efficient, cost-effective national payments system with immense public economic benefit.

Quite bluntly, existing Federal Reserve services need not meet any marketplace test of economic efficiency. Member banks, faced with the need to recover as much return as they can on their unproductive reserve balances, have a strong incentive to use any service the Federal Reserve provides. Many banks are using services provided by the Federal Reserve that could be provided either at less cost or with greater convenience or efficiency by the private sector.

What kind of a pricing system would provide the marketplace tests needed to stimulate greater efficiencies in the payments system? We recognize that the mechanics of pricing and cost allocation are complex, and for the Federal Reserve, the task will be extraordinarily difficult. Since the Federal Reserve’s decisions have great consequence for competition in payments services, it is important that the criteria for pricing be open to public view and discussion.
Prices charged banks for the Federal Reserve’s services must reflect the cost to the Federal Reserve, allocated fully and equitably among all services. We believe that the service and pricing structure must incorporate the principle that availability of funds to banks will be based uniformly on the Federal Reserve’s actual collection patterns.

The American Bankers Association, recognizing the complexity of this problem, has commissioned a further set of surveys and studies on it. So far the Federal Reserve has not made public its own thoughts on the subject in sufficient detail to permit useful analysis and discussion.

We would anticipate that the payment of interest on reserves and resultant relief of the membership problem would bring an end to the perversion of the Federal Reserve’s service role in the cause of aiding membership retention. While we believe firmly in the value of Federal Reserve independence in establishing monetary policy, we believe its approach to operating services to be amenable to continuing public discussion and debate.

In our view the worthwhile objective of arresting the decline in membership has lured the Federal Reserve into adopting predatory tactics in promoting its services, into arbitrary and discriminatory subsidy of individual banks, and into an unhealthy bending of its own service regulations and operating circulars.

I will cite a specific example from our own experience. In 1976, Philadelphia National, as part of its competitive effort to obtain new correspondent banking business, worked out an agreement with four banks in the Johnstown, Pa., area to provide certain check-clearing and check transportation services that were then unavailable from the Federal Reserve and which other private institutions had chosen not to offer competitively. After the agreement had been worked out in detail, the Philadelphia Federal Reserve Bank, notified of it, intervened and offered the identical service to the four banks at no direct cost to them.

Naturally, the banks chose the Federal Reserve’s offer over ours. In order to provide the service, the Federal Reserve had to incur costs that I am convinced we could have met, had the Federal Reserve been required to charge a fair price for the service.

In this instance, the Federal Reserve directly undercut a private initiative, presumably to engender the good will of four banks, and in so doing, provided a de facto subsidy to those institutions funded by the local Federal Reserve’s profits on the investment of interest-free reserve balances required to be maintained with it by district members, including ourselves.

This and similar adventures raise serious public policy issues about the current attitude of the Federal Reserve System toward competition. We have done extensive analyses of the service pattern of the Federal Reserve, not only within the Third District, but throughout the System. Our analyses clearly show that the effect of variations in check-clearing schedules, sorting requirements, transportation patterns, and policy on float throughout the System is to: (1) discriminate in services made available to banks in different districts; (2) discriminate between larger and smaller banks; and (3) discriminate in effect by geography within a single district, the Third.
We also have direct knowledge of instances in which the Federal Reserve has violated its own service regulations in individual cases; for example, permitting a bank to receive service under the 5,000-unsorted check program, even though its daily average considerably exceeded 5,000 items.

Our experiences with this kind of competition have increased, in our minds, the need for prompt action such as proposed in the present bill to alter this pattern of behavior by the Nation’s central bank, principal regulator and lender of last resort.

To summarize: (1) We believe that the membership problem of the Federal Reserve System needs urgent action.

(2) We support the thrust of Senate bill 3304, with the comments I have noted.

(3) Once we get past the immediate membership problem, we believe that the realistic and equitable pricing of the Fed’s services will encourage the development of flexible, efficient, and cost-effective national payments and aline the Federal Reserve’s orientation to the achievement of those important interests.

Thank you, Mr. Chairman.

[Prepared statement of Mr. Ravenscroft follows:]

STATEMENT OF RICHARD S. RAVENSCROFT, PRESIDENT PHILADELPHIA NATIONAL CORP.

Mr. Chairman and distinguished committee members: I am Richard S. Ravenscroft, president of the Philadelphia National Corporation, a one-bank holding company whose principal subsidiary is the Philadelphia National Bank. Philadelphia National is the 29th largest U.S. commercial bank based on deposits, with a full range of consumer and commercial banking business, including an extensive correspondent banking business focused on clearing and payment services. The corporation’s other subsidiaries operate in the areas of mortgage banking, consumer and commercial finance, government securities trading and investment advisory services and come within the supervisory jurisdiction of the Federal Reserve System.

We want to thank you for the invitation to present our views here today on Senate 3304, the Federal Reserve Requirements Act of 1978.

We favor the legislation because it would improve the determination and execution of monetary policy, the soundness of the banking system, and the efficiency of our national payments system. Further, it would end the abuse of the Federal Reserve's operating services to fight the problem of membership attrition, which works to the detriment of private competition and initiative.

We are a member of the Third Federal Reserve District. Within our District we have seen 23 banks withdraw from the system from the end of 1970 to the beginning of this year. More have left this year and still more appear on the brink of leaving, especially in the present climate of high inflation and interest rates. This experience parallels the nationwide trend reported by Chairman Miller in his recent testimony.

We are deeply concerned with the implications of this decline in the proportion of bank deposits subject to reserve requirements as it relates to the process of establishing and carrying out monetary policy. This trend also restricts banks' access to the resource of the nation's lender of the last resort during periods of severe economic stress. From our perspective of close day-to-day involvement with the Federal Reserve System, it is clear that the environment in which we operate has changed considerably as the Federal Reserve's membership problem has deepened and the Federal Reserve in turn has used every available mechanism in an unsuccessful effort to respond.

The first and perhaps most controversial of the proposals in Senate 3304 would require the establishment of reserve balances at the Federal Reserve for all "transaction accounts" in depository institutions. By defining transaction accounts to include such services as negotiable order of withdrawal (NOW) accounts in thrift institutions and share draft accounts in credit unions, this would
extend reserve requirements not only to all but the smallest member and non-member banks but also to certain deposits in other financial institutions.

There is strong logic to this provision. It would improve control over monetary growth by bringing more of the basic money supply under the Federal Reserve's direct influence. It would also provide more uniform governmental treatment of deposits which perform basically similar economic functions. On the other hand, we recognize very practical problems with passage of legislation bearing this provision and would recommend its exclusion, if necessary, so as to not protract debate.

In the longer view, we see issues of regulatory supervision and system membership as directly related to the major structural and technological changes which have reshaped our financial system and institutions. Today, commercial banks compete for sources of funds and for earning assets with a host of other institutions—thrifts, credit unions, foreign banks, some insurance companies and brokerage houses, the commercial paper and capital markets, and the financial services units of major commercial and retail companies. In view of the urgency of correcting the membership problem, we feel that the issue of even-handed treatment of all types of institutions offering financial services should be set aside, but we do note that the costs, restrictions, and inflexibilities of membership lie upon those commercial banks—small, medium, and large—who have remained within the system.

The most effective incentive to retain and build membership in the Federal Reserve System lies in the payment of interest on reserve balances. We oppose as discriminatory any proposal to limit the rate of interest paid on reserve balances over $25 million, or any other arbitrary amount.

We are aware that there are other ways to reduce the burden of membership, for example by reduction of reserve levels or by provision for holding some fixed portion of reserves in the form of government securities. However, the payment of interest on reserves seems to us to be the most straightforward and simple approach, and the one least encrusted with side issues related to the Federal Reserve's monetary role.

The reserve requirement associated with Federal Reserve membership is in effect a special tax on member banks or, more precisely, a levy based upon the sum of deposits placed in those banks by individual customers. Chairman Miller recently estimated the current level of that “tax” as $650 million a year; we believe that is a most conservative estimate. We recognize the concern of the Treasury about the impact of this proposal on its revenues, particularly as it faces the prospect of financing budget deficits of truly heroic dimension. In turn, the Treasury should recognize that without prompt, decisive relief, membership will continue to erode, probably at an accelerated rate. In turn, reserve balances held by the Federal Reserve will decline, and with them the Treasury's revenues. Chairman Miller has estimated that these losses will grow by at least $80 million for every year there is no relief. If membership were made attractive again, the reverse sequence could be expected. On balance, it is misleading to characterize interest payments as the most straightforward and simple approach, and the one least encrusted with side issues related to the Federal Reserve's monetary role.

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The effect of the tax represented by the reserve requirement becomes almost diabolical as member banks are forced by competitive pressures and economic reality to move toward paying interest even on customer's transaction balances,
as they have been for more than a decade on temporarily idle balances. Its effect is also on the lending side. It seems curious that to achieve the same effective margin on a loan to a commercial borrower, United States commercial banks must charge roughly a half percent higher interest than that charged by a foreign bank or a nonregulated competitor and that all of that mark-up flows through to those of the United States Treasury.

It is in this context that I view comment that interest payments on mandated reserves represent a "gift" to the largest banks. It should come as no surprise that the largest banks receive the largest sums on their reserves: they have more customers providing more deposits upon which those reserves are based, and those idle sums currently provide the largest share of the revenues turned over to the Treasury. There is nothing illogical or unfair about returning interest payments to all banks, regardless of size, in proportion to the amount of earning opportunities they are forced to forgo by maintaining sterile reserves at the Federal Reserve.

I don't see that any useful public purpose is served by punitive or discriminatory provisions aimed at the largest banks, or the fifty largest. Our banking system is based on a diversity of institutions; we need our large banks, which provide a breadth and sophistication of services the small ones cannot, as well as our small banks, which provide more convenient, often more personal services and attention.

A bank becomes and remains large because individuals and businesses make a cumulative set of explicit decisions to place their deposits with that institution. It is, therefore, that many of our large banks that remain profitable today, judged by the standards of business enterprise in general, the performance level of the banking peers, and the requisites of the capital markets. Because of domestic branching and line of business restrictions, the direct operations of many of the largest banks are confined to areas of declining economic vitality. Because of their central urban locations they probably face severe inflationary costs and growing local tax burdens. They have felt most directly competition from foreign banks not subject to the same reserve requirements and restrictions, as well as from other nonregulated markets and institutions providing commercial and consumer credit services. Large banks bear a disproportionate share of the huge and still growing cost of government regulation, reporting and examination. They are already discriminated against in the progressive way in which the required reserve balance is calculated. Any additional discriminatory provisions would tend to worsen a situation which has already seen a number of major banks, weakened by these pressures, fall prey to foreign opportunists.

Those who have suffered most from these circumstances have been the shareholders who, by and large are individuals or trusts or pension funds organized on behalf of individuals. About 80 percent of Philadelphia National's stock is held by individual's or by fiduciary intermediaries on behalf of individuals, with the average individual holding less than $5,000 at current market value. Across the nation, in small banks and large, bank earnings provide benefits of dividend and capital appreciation to people of ordinary means.

We have stated our philosophical basis for supporting interest payments on reserve balances. In my view, these reasons are fortified by some very practical considerations which relate to the simultaneous unbundling and explicit pricing of the Federal Reserve's operating services. Although Philadelphia National is a heavy user of Federal Reserve services and thus faces substantial charges for them, we strongly favor this approach. An equitably structured pricing system would permit private competition and innovation in payment services, fostering a truly efficient, cost-effective national payments system with immense public economic benefit.

Quite bluntly, existing Federal Reserve services need not meet any marketplace test of economic efficiency. Member banks, faced with the need to recover as much return as they can on their unproductive reserve balances, have a strong incentive to use any services the Foreign Reserve provides. Many banks are using services provided by the Federal Reserve that could be provided either at less cost or with greater convenience by the private sector.

What kind of a pricing system would provide the marketplace tests needed to stimulate greater efficiencies in the payments system? We recognize that the mechanics of pricing and cost allocation are complex; for the Federal Reserve, the task will be extraordinarily difficult. Since the Federal Reserve's decisions have great consequences for competition in payment services, it is important that the criteria for pricing be open to public view and discussion.
Prices charged banks for the Federal Reserve's services must reflect the cost to the Federal Reserve, allocated fully and equitably among all services. We believe that the service and pricing structure must incorporate the principle that availability of funds to banks will be based uniformly on the Federal Reserve's actual collection patterns. The American Bankers Association recognizing the complexity of this problem, has commissioned a further set of surveys and studies on it. So far the Federal Reserve has not made public its own thoughts on the subject in sufficient detail to permit useful analysis.

We would anticipate that the payment of interest on reserves and resultant relief of the membership problem would bring an end to the perversion of the Federal Reserve's service role in the cause of aiding membership retention. While we believe firmly in the value of Federal Reserve independence in setting monetary policy, we believe its approach to operating services to be amenable to continuing public discussion and debate.

In our view, the worthwhile objective of arresting the decline in membership has lured the Federal Reserve into adopting predatory tactics in promoting its services into arbitrary and discriminatory subsidy of individual banks, and into an unhealthy bending of its own service regulations and operating circulars.

I will cite a specific example from our own experience. In 1976, Philadelphia National, as part of its competitive effort to obtain new correspondent banking business, worked out an agreement with four banks in the Johnstown, Pa., area to provide certain check-clearing and check transportation services that were then unavailable from the Federal Reserve and which private institutions had chosen not to offer competitively. After the agreement had been worked out in detail, the Philadelphia Federal Reserve Bank, notified of it, intervened and offered the identical service to the four banks at no direct cost to them. Naturally, the banks chose the Federal Reserve's offer over ours. In order to provide the service, the Federal Reserve had to incur costs that I am convinced we could have met—had the Federal Reserve been required to charge a fair price for the service. In this instance, the Federal Reserve directly undercut a private initiative, presumably to engender the good will of four banks, and in so doing, provided a de facto subsidy to those institutions funded by the local Federal Reserve's profits on the investment of interest-free reserve balances required to be maintained with it by district members, including ourselves.

This and similar adventures raise serious public policy issues about the current attitude of the Federal Reserve System towards competition. We have done extensive analyses of the service pattern of the Federal Reserve not only within the Third District but throughout the system. Our analyses clearly show that the effect of variations in check-clearing schedules, sorting requirements, transportation patterns and policy on float throughout the system is to:

1. Discriminate in services made available to banks in different districts;
2. Discriminate between larger and smaller banks;
3. Discriminate in effect by geography within a single district (the Third).

We also have direct knowledge of instances in which the Federal Reserve has violated its own service regulations in individual cases—for example, permitting a bank to receive service under the 5,000-unsorted check program even though its daily average considerably exceeded 5,000 items. Our experiences with this kind of competition have increased, in our minds, the need for prompt action such as proposed in the present bill to alter this pattern of behavior by the nation's central bank, principal regulator and lender of last resort.

To summarize:

1. We believe that the membership problem of the Federal Reserve System needs urgent action.
2. We support the thrust of Senate Bill 3304, with the comments I have noted.
3. Once we get past the immediate membership problem, we believe that the realistic and equitable pricing of the Federal Reserve's services will encourage the development of flexible, efficient and cost-effective national payments and align the Federal Reserve's orientation to the achievement of those important interests.

Senator RIEGLE. Let me thank each of you for your testimony. Let me move now to some areas of questioning. Let me direct the first question, if I may, to Mr. Heimann and Ms. Greenwald.
There are several proposals now to have universal reserve requirements with a very high exclusion, so that small banks would not have to bear the burden of reserves.

Chairman Reuss in the House bill has $100 million exemption, and the Federal Reserve says it favors a $50 million exemption.

My questions are two: First, do you think there is any problem in granting such a large exemption for reserve requirements?

And, two, several witnesses yesterday said that such a large exemption could induce State-chartered banks to switch charters and become national banks. I wonder if either of you see this as a likely possibility.

Ms. Greenwald. I don’t have any problem with a $100 million exemption. Certainly it is not too high for monetary policy. Monetary policy isn’t operative through reserve requirements anyway, it hasn’t been for years and years, way before there ever was a membership problem. The reason is that it is considered a very clumsy tool, a sledge hammer approach, an open-market operation has been used extensively, and virtually exclusively for 40 years.

So I don’t have to worry about a high exclusion for monetary policy.

I think it is a good idea because it excludes the very small banks, who are very numerous, and we have a financial burden placed on them by having their reserves placed in non-interest-bearing securities.

So I think it is a good viable proposal for getting the Fed out of worrying about the membership problem, and into finally getting on with the work of being a central bank.

Mr. Heimann. We do not have a problem with an exclusion for banks of a certain size. We believe that the burden on smaller banking institutions in this country, the regulatory burden itself, has to be reexamined and reevaluated.

The question is what is the magic number. There is to some degree an attempt by all parties to seek a correct sum, whether it is $50 million or $100 million, I don’t think we really know. If this is to succeed, the concept will have to be flexible, predicated upon the experience of managing this new system of universal reserves, with exclusions for certain institutions of a certain size.

Flexibility as to the amount would be key. There must be a methodology which will not discourage banks from growing over a certain size or finding techniques by which the institution’s growth is curtailed because of the limitation, be it $50 million or $100 million, that makes them subject to reserves.

But I am sure the intelligent thought process of all parties involved can come up with a plan that will solve the problem.

I would also like to say that part of what I have been hearing has been that plan A or plan B or plan C will result in massive switching of charters, either from nationally chartered to State chartered, or from State chartered to nationally chartered.

I would suggest that is something of a bugaboo. I have been consistent as a State supervisor and as Comptroller of the Currency, and I believe Commissioner Greenwald agrees with the thought process. If, in effect, we have universal and uniform reserves, with open access, then this question of pushing one system, forcing or making it terribly attractive for banks to switch charters is not a real problem—it is more of a strawman.
Ms. GREENWALD. Also I think the point we both made in 1976 in the testimony is if, in fact, the State banking system is existing on a subsidy from the Federal Government, that is, it is cheaper to be a State-chartered bank, that is hardly any reason for the dual banking system. So if that is going to be the death knell for it, it probably should go.

Senator RIEGLE. One of the questions that we would like to pin down is whether the difference in reserve requirements between zero on the one hand, versus whatever the States might require, wouldn't this still induce some switching around? I gather you think not.

Ms. GREENWALD. No, I think if we are going to have this game that everybody is going to have the same reserves, but only members get access to the discount window, and only members have access to the Federal Reserve services, yes, then what is the point of not being a member. You are crazy in that situation not to be a member, either by becoming a State member or becoming a national bank, whatever advantages there are in that sense.

So, yes, if you go to universal reserves and leave everything else in place, you will end up with the Federal Bank Commission over at the Federal Reserve System.

Mr. HEIMANN. I agree. Open access really solves the problems to which we were addressing ourselves. If it is restricted, you could have switching.

I might add, Senator, that everyone running a bank has reserves. It is a question of where those reserves are held and whether they earn interest. Imposition of reserves by the Federal Reserve to Federal Reserve members is not a unique happening. I don't think there is a bank supervisor in the world that doesn't view reserves with peace of mind and peace of heart. Reserves are a requirement. It is a question of the size of the reserves and how they are held, whether they earn interest.

Ms. GREENWALD. They are a requirement of State law. It isn't simply that it is a well-run bank, State law requires reserves. I am familiar with the Massachusetts reserves, and they are close to the Federal reserve requirements. It is not the level of reserves that differs, it is how you hold them. The State says if you hold say 20 percent for a central city bank, you hold them in interest-bearing government securities. That is the difference.

Mr. HEIMANN. To be perfectly precise, in New York State reserves are set at 1 percent below what the Federal Reserve sets them. In other words, the Federal Reserve sets them and the New York Board adapts to it, so that is how the system works.

Senator RIEGLE. Mr. Ravenscroft, you said in your statement that the most effective incentive to retain and build membership in the Federal Reserve System lies in the payment of interest on reserve balances.

Each of our witnesses today disagrees. They think universal reserves would be better. I am wondering why you think interest payment on reserves would be more effective?

Mr. RAVENSCROFT. Obviously, the one is an order mandated by legislative fiat, while the other is an economic incentive. If I were to choose between a legislative stick and an economic carrot, I would prefer the carrot. For one thing, I believe there is a certain public
benefit from permitting banks to walk out the door of a particular regulatory agency if the manner in which that agency is conducting its affairs is unreasonably oppressive.

That would not be the case if universal reserves led to de facto supremacy of the Fed in the regulatory/supervisory junction. The end of that road would be to cut off the opportunity for institutions to express preferences in response to opportunities or perhaps inflexibilities among the Federal Reserve Board and its various districts.

So I think an economic incentive in this case would produce the desired result. I know that legislative fiat would also. But I prefer the one to the other.

Senator RIEGLE. I notice you are shaking your head, Mr. Heimann.

Mr. HEIMANN. I am afraid we may have apples and oranges mixed in the same basket. I happen to believe in the dual banking system, and that institutions should have some choice.

However, I don’t think that the answer to the question would be precisely the same, or vaguely the same as Mr. Ravenscroft’s. At the present time we are having changes in the dual banking system. Those changes exist because it has become unprofitable for institutions to remain in the Federal Reserve, the national banking system, simply because of what is euphemistically called bottom line considerations.

So the changes that are taking place now are not predicated upon the quality of supervision, State versus national supervision, they are determined by very real and completely comprehensible economic factors. That is, they affect the profitability of the individual institution and I may add, the board of director’s liability as a board to try to keep the profitability, for which they, representing the shareholders, are responsible at the highest degree consistent with safety and soundness.

Again, I think it might be worth repeating what the Commissioner and I have suggested, though we didn’t prepare this ahead of time—I didn’t know what her testimony was going to be, and she didn’t know what mine was going to be. If you have universal reserves and open access, that means all like institutions can make the suggested change Mr. Ravenscroft was talking about free of any extraneous factors, such as profitability.

Then if the institution feels the quality of supervisor A is better or more progressive or more compatible than supervisor B, then that change can truly take place in the dual-banking system, without the constraint as to whether or not it increases or decreases the profitability. So that I would argue, and intellectually it is perfectly consistent, that universal reserves with open access and of course pricing of Federal Reserve service, all as one package, as has been suggested, actually in many ways leaves the freedom of choice much more intellectually honest than it is at the present time.

Mr. RAVENSCROFT. If I may comment on that—

Senator RIEGLE. Please.

Mr. RAVENSCROFT. I think that is all well and good in a closed system. But as I indicated in my testimony, we are not in a closed system. We compete for earning assets and for sources of funds with other institutions. You can impose universal reserves on all regulated institutions, and we are still going to have the problem as to the division
of the financial system among regulated institutions and the non-regulated with which we must compete.

So I think in a narrow closed way that may be possible, it may snuff out evidence of the problem. But we have got competitors enjoying economic and operating advantage by not being regulated who would not be regulated under any of these proposals.

Mr. Heimann. May I just continue this dialog? To the degree stated, that is correct. It is closed to the commercial banking system. But as suggested by the Comptroller’s Office and others, we believe that universal reserves should be to all like deposit-taking institutions and therefore in our testimony—and this has been set for some period of time—we believe it should be extended to the thrift institutions and the credit unions over a period of time, which partially answers the problem Mr. Ravenscroft is talking about.

Second, with respect to the foreign banking institutions operating in the United States today, a matter which he brought up in his testimony, we also believe that reserve requirements, the same level of requirements—and we have so testified and so has the Fed—should apply to those institutions.

Now when we get outside of these regulated areas of the commercial and thrift industry, to such areas of activity as Sears Roebuck, which is in the transaction business, or American Express, or others, to this point Congress has not indicated its belief that there was a need or it was in the public interest to regulate such industry.

So therefore I think that the conversation has to be delineated to those industries or those areas of industry which have been placed under regulation by the will of the Congress for good public purposes.

We support the extension of universality of reserves, uniformity of reserves, to all of them, though I must put in the caveat that it would have to be phased in over a period of time, it could not be done immediately because of the financial structure and the earning structure of the thrift institutions, particularly.

Ms. Greenwald. My testimony also talked about the Fed setting levels of required reserves for all depository institutions with transaction accounts. I am supporting that in the setting of nonmembership. It would be universal nonmembership, with the Fed setting universally required reserves for transaction accounts, any depository institution.

Senator Riegel. Mr. Ravenscroft, you are president of a large correspondent bank, who compares with the Federal Reserve in supplying services to other banks. You favor pricing, so that you can more effectively compete.

A story in Business Week last February indicated that the Philadelphia Federal Reserve is doing everything it can to take your customers away from you. As a matter of fact, you gave us one illustration today. In your statement you said there was some, and I quote, “perversion of the Federal Reserve’s service role in the cause of aiding membership retention.”

I think it would be important for you to tell us in some detail exactly what the Philadelphia Federal Reserve is doing with its services to aid membership, and I am wondering if you could give us further examples of the Fed’s changes in operations which you feel have been made to influence membership.
Mr. RAVENSCROFT. Senator, sitting immediately behind me is a colleague of mine, Mr. Norton, executive vice president of the bank, with extensive experience through his career in operations, data processing, and now the man to whom the entire correspondent banking function reports.

I wonder if you would permit him to respond?

Senator RIEGLE. Yes; why don’t you come forward and bring your chair up and share that microphone.

And would you repeat your name again for the record?


With regard to the areas of complaint that we have had with our local Federal Reserve bank, it really stems, I believe, from their approach of trying to use the service route to try to stem the tide of attrition in membership.

And in the process we believe that there have been instances where there has been a bending of the Federal Reserve regulations and operating rules in order to be able to accomplish these ends.

As a major correspondent bank within our district, we have had serious communications problems with the Federal Reserve in that there would be a change of operating rules and procedures that would be communicated to smaller banks within the district, but would not be adequately communicated to us through both were members of the same system. One of the specific areas relates to an operating rule which apparently originated sometimes in the late fifties or early sixties, whereby the Federal Reserve banks would permit any member bank that had an average of 350 checks per day or less to deposit these checks with the local Federal Reserve, unsorted, so that the Federal Reserve itself did the sorting.

Of course this was in direct competition with the services being provided by other large member correspondent banks.

That number was gradually increased, from 350 to 1,000, to 2,000, and ultimately up to 5,000 checks per day. And in so doing, the level of competition with correspondent banks continued to increase: 5,000 checks would take a bank into a size that would be approximately $75 to $100 million. Our concern was that this limitation would rise and rise without end.

The other consideration was also of significant importance to us because it got to the issue of implicit pricing. As you know, in the correspondent business there are explicit prices established for each type of service, and this is equated to the level of balances that must be maintained by either a member of the system or nonmember, that elects to have a service.

In the third district, unlike all of the other district systems, under the so-called 5,000 rule the Federal Reserve Bank of Philadelphia elected not only to receive these checks unsorted, but also to give next-day immediate availability.

So therefore, as a matter of policy, they were making availability of credit into reserve balances clearly in excess or faster than the checks themselves could be collected and therefore increasing the total Federal Reserve liability.

The Third District also has a very unique transportation system, which is completely subsidized by the Federal Reserve bank. No other Federal Reserve bank provides comparable service.
All of these, I believe, are examples of the ways that the Federal Reserve is competing very effectively against its own members.

Senator Riegel. I am wondering if you are aware of any other part of the Federal Reserve System doing what you are experiencing in your area?

Mr. Ravenscroft. I think our experience and information, based on conversations with banks around the country is that the Fed with which we compete is surpassed by no other district in its aggressiveness.

Senator Riegel. Ms. Greenwald, what have you seen? From your vantage point, have you seen this anywhere in New England?

Mr. Ravenscroft. There are not thrilling issues in the political sense, and they are not easy to describe. On the other hand, we certainly have seen an erosion of potential markets. As I referred in my testimony, we haven’t seen any pickup in Federal Reserve membership, so we think these actions are destined to fail. But it happens to raise very serious questions as to the extent to which we can, for example, justify investment in correspondent banking—the hardware and software and people—for the ensuing decade.

As I mentioned, we are not here to get into a fight or to air our disputes with the Fed. We are here because we feel that the bill under consideration addresses in a very realistic sense the underlying problem, and we have seen the effects of this on our volume, on our profits, on our strategic plans.

They are not terribly exciting or easily described issues, but we have learned what the rhinoceros looks and sounds like as it creeps up on us.

Senator Riegel. Ms. Greenwald, did you want to comment?

Ms. Greenwald. The Fed clearly has used these services as a means of keeping members. The only example that comes to mind in New England is the Fed’s decision first not to let thrifts into the automated clearing house, and then to do so at a discriminatory pricing, until the Justice Department intervened. Their motivation was to say, see, we do something for our members.

Mr. Heimann. Senator, if I may, as you know, the Comptroller’s Office has felt for some period of time that this process, which has been given the unlikely name of unbundling, should apply in one form or another to the Federal Reserve and its system. Certainly since we are supporters of the NOW accounts, it applies to the consumer receiving interest on his demand deposit and paying for services.

Of course we have also felt quite strongly it should apply to the correspondent banking system. I assume that this follows that the Philadelphia National Bank would ascribe to the same theories as it follows all of the way through. If you have unbundling, it should be an unbundling across the board from the consumer to the bank.

Senator Riegel. Yesterday the members of a panel of bankers from small banks said that correspondent banks have unbundled their services and are charging explicitly for services. They also said they receive implicit interest on their demand deposits. Why aren’t such implicit payments a violation of the prohibition against payment on demand deposits?
Mr. Heimann. I frankly don’t know what it means, an implicit payment on a demand deposit. There are examples of that in our society which probably are bending the law. For example, giveaway programs; when you open a new account at a savings bank, those giveaways are a form of payment, even though they aren’t calculated in the rate of interest for regulation Q limitation purposes.

But I am not sure what they mean by implicit. I would say from the supervisor’s point of view, any supervisor, that he would prefer to see explicit payment on demand deposits and explicit charge for services. That is the only system by which we can calculate with a fair degree of precision and accuracy whether the services of the institution are being paid for directly or indirectly.

Senator Riegle. Ms. Greenwald, let me ask you, do you foresee any problems for small Massachusetts banks if the Federal Reserve were to price its services and compete with correspondent banks?

Ms. Greenwald. Do I see any problems?

Senator Riegle. For the smaller banks in Massachusetts. Do you see any adverse impact?

Ms. Greenwald. No, especially if you go along with the Reuss plan of exempting small banks from required reserves, that would have more of an impact on them, if they had to suddenly become members of the Fed and pay for services.

To go back, we have very few State-chartered members of the Fed in Massachusetts. I believe we are down to six.

Senator Riegle. Let me ask one more question, if I may. If the Federal Reserve is to become a true central bank, with universal reserves, open access to services and the discount window, the role of the regional reserve banks may become more important.

Should steps be taken to make those reserve banks more accountable to the Federal Government, perhaps by changing the structure of the boards of directors, and proving appointment of the presidents by say the Federal Reserve Board, with confirmation by the Senate?

Ms. Greenwald. I think that makes sense, regardless of what else you do.

Senator Riegle. I like the idea, too. We just started a vote on the floor, which I must go to shortly, as I need to talk to some people before. I know how I am going to vote. Also I want to talk to some other people before they vote.

I appreciate very much your testimony today, and hope you see you all again soon.

Mr. Heimann. Thank you, Senator.

Senator Riegle. The committee stands in recess.

[Thereupon, at 11:45 a.m. the hearing was recessed, to reconvene at 10 a.m. the following day.]
STATEMENT OF CHAIRMAN PROXMIRE

The Chairman. The committee will come to order. This is the fourth and final day of hearings on reserve requirements and solutions to the Federal Reserve’s loss of membership.

On Monday Chairman Miller maintained that “Membership is not essential, and it’s rather unique in the United States in terms of central bank functions, and so it would be appropriate for us to think broader.” I guess grammatically that should be “more broadly,” but he said “broader.”

No Federal Reserve spokesman, according to the committee staff, has ever gone that far before in explaining the problem the Federal Reserve faces because of attrition of members.

What needs to be considered is to have the central bank in a position to implement monetary policy, provide access to the discount window and its payment services on a fair and equal basis for all banks, regardless of regulatory affiliation, and to do all this without the consequences of losing membership if it makes a particular decision.

The Federal Reserve, the Treasury, the Comptroller of the Currency, among others, believe that universal reserve requirements of some kind would be the best and most permanent solution to the problem facing the Federal Reserve. It would also allow the concept of membership in the Federal Reserve to become a nonissue. Open access to the discount window and to Federal Reserve services on the basis of price rather than membership status would be possible. That would be a major improvement to the present situation in which membership considerations influence decisions.

The universal reserve requirement also would limit the exposure of the Treasury to loss of revenues.

We have had a proposal, as you all know, to pay interest on reserves, which has received the support of a number of Senators. Not this one. It seems to me if we go that route, the cost to the taxpayers would be very substantial inasmuch as the Federal Reserve revenues of course are returned to the Treasury. If the market rate of interest is paid, and
eventually we might get to that level on reserves, it is my understand-
ing it would cost $1½ billion. At a time when a number of Senators, in-
cluding those in the forefront of advocating payment of interest on
reserves, are opposed to spending as much money as we are spending
on food stamps, and are cutting back in other areas, it seems to me it
is very very hard for us to maintain we should pay interest on reserves,
and benefit bankers.

Not that bankers don't need benefit, but their profits aren't too low.
I think it should be apparent to anybody who has any political under-
standing at all that this route is fraught with all kinds of difficulties.
If we try to change a policy that we have followed ever since the advent
of this country, and begin to pay interest on reserves, there will be
problems.

Our first panel of witnesses is a very distinguished group of econo-
mists, Lester Chandler from Princeton, James Pierce from the Uni-
versity of California at Berkeley, and Jon Brown, staff attorney for
the Public Interest Research Group.

If you gentlemen would come forward, we would be happy to hear
from you. So we will have time for questions, I am going to ask that
we run the time clock and everybody will have 10 minutes for his oral
statement. Anything you don’t get a chance to say orally will be put in
the record and made available to the committee and to other Senators.

When you start, the green light will go on, it will stay on until you
have spoken for 9 minutes, then the yellow light will be on for 1 minute,
and then the red light, of course you know what that means.

Professor Chandler.

STATEMENT OF PROFESSOR LESTER CHANDLER, ECONOMICS
DEPARTMENT, PRINCETON UNIVERSITY

Mr. Chandler. Thank you, Mr. Chairman, for the opportunity to
testify this morning. I wish to say that I endorse the proposed legisla-
tion, if, in your judgment, it is the most and best legislation on the
subject that can achieve adoption by Congress this year. Knowing the
disastrous fate of more comprehensive reform bills considered by Con-
gress during recent years, I do not wish to urge extensions or amend-
ments that would lead to no legislation at all.

Under these conditions, I approve the proposed legislation as a first
step toward reform of existing arrangements, which are highly dis-
criminatory, distorting in their economic effects, and ill-designed to
facilitate monetary management.

At the heart of the present problem is the motley array of legal
reserve requirements that are highly discriminatory as between banks
that are members of the Federal Reserve and those that are not. The
situation will be worsened if thousands of thrift institutions are per-
mitted to create NOW accounts and other transactions balances with-
out meeting the same reserve requirements as those imposed on member
banks.

As you know, the only things countable as legal reserves for member
banks are cash in vault and deposits at the Federal Reserve, neither of
which pays any interest. Congress presumably ordered the imposition
of these requirements because it considered them necessary, or at least
useful, for purposes of monetary management, as a means of setting
and stabilizing the size of the money multiplier. However, an incidental effect of these reserve requirements is a tax on member banks. The tax is in the form of the earnings that banks must forego in holding some of their funds in the form of sterile required reserves instead of earning assets. These tax revenues accrue in the first instance to the Federal Reserve in the form of interest on the earning assets acquired in supplying the required reserves, but a major part of these revenues is then contributed to the Treasury.

The reserve requirements on nonmember banks, as determined by the various States, are far different and far less onerous. Illinois deals with the matter in a refreshingly forthright manner; it has no reserve requirements at all. At least seven other States do impose reserve requirements, but permit all the requirements to be met with earning assets, such as Treasury securities, commercial paper, Federal funds and negotiable certificates of deposit. A number of other States also permit a part, in some cases a large part, in excess of 50 percent, or requirements to be met with such earning assets. Most of the remaining requirements can be met with deposits at other banks, many of which would be held anyway for business reasons. Only a handful of States, only three in fact, require that any fraction of reserves be held as cash in vault, and this fraction is typically quite small, usually below one-fifth.

In short, the net cost to nonmember banks of meeting their reserve requirements is very small relative to the costs imposed on member banks. In effect, banks that remain outside the Federal Reserve receive a Federal subsidy in the form of exemptions from the tax that would be imposed on them if they became members of the Federal Reserve. My rough estimate is this subsidy is now costing the Treasury at least $600 million a year.

Moreover, most of the reserve requirements applicable to nonmembers are of little or no use for the purpose of monetary management. To be useful for this purpose, the supply of the things countable as legal reserves must be subject to control by the Federal Reserve. The latter can control the supply of cash plus deposits at the Federal Reserve. But neither the Federal Reserve nor any other central agency can control the supply of the wide array of assets presently countable as legal reserves for nonmember banks.

Though I shall later criticize some of its details, I approve in principle the proposal that federally determined reserve requirements be applied to transactions balances created not only by member banks, but also by other insured commercial banks, and by thrift institutions, and that the only assets countable as legal reserves be cash in vault and deposits at the Federal Reserve held directly or indirectly. Adoption of this proposal would reduce markedly the present discrimination against member banks and would provide a set of reserve requirements more helpful for purposes of monetary management.

If past experience provides any guide, this proposal will meet strong opposition. Many will argue that it violates the principle of dual banking. This argument must be faced and should be rejected. There are, of course, many aspects of bank regulation that are properly in the hands of State legislatures and State banking authorities. But monetary management is not one of these. The Constitution explicitly delegates to Congress the exclusive power "to coin money and regulate the value
thereof,” and at least implies that Congress should take such actions as are necessary or useful in meeting this responsibility. Congress has decided that reserve requirements on member banks are necessary or useful for this purpose. If this is true for a small $20 million member bank, why should a $100 million bank that elects to remain outside the Federal Reserve be exempt?

I approve also the proposal that the Federal Reserve charge for the services that it provides to financial institutions, instead of providing them free, and that the prices charged for the various services be in line with their costs of production. A large part of these charges will probably be passed on to consumers in the form of higher prices for financial services, but this is desirable in order to encourage economy in the use of resources. Free services are invitation to waste. Consumers now receive large amounts of free services, partly because the Federal Reserve provides free services to their banks, but more because their banks provide free services in lieu of interest on demand deposits. Specific pricing of Federal Reserve services would bring some economy in the use of resources, but much larger economies could be achieved if banks were permitted to pay interest on demand deposits and the banks were thus encouraged to make specific charges for their services.

Charging specific prices for financial services by both the Federal Reserve and other financial institutions takes on special importance now because of the potentialities of the electronic funds transfer system now in process of development. This new system can be far more efficient than the old system based on checks, but only if it can divert consumers away from the use of checks and achieve a high volume of transactions.

But the high costs of the paper-based system are not now apparent to consumers who receive services free, so that incentives to shift to the more efficient system are seriously weakened. The more efficient electronic fund transfer system will develop more rapidly if the services of this system and the services of the paper-based system are priced specifically in line with their relative costs of production.

The third title of the bill proposes that the Federal Reserve be authorized to pay interest on required reserves held in the form of balances at Federal Reserve banks. I approve this proposal in principle, though I shall later criticize some of its details. I shall also contend that if only some given amount of Treasury revenues can be sacrificed in the interest of reform, first priority should be given to reforming the reserve requirement themselves, and only a second priority to the payment of interest on required reserves.

Now for comments and criticisms of some of the details of the proposals, I do not like at all the distinction between demand deposits on the one hand and NOW accounts and share draft accounts on the other hand, for the purpose of fixing the level of reserve requirements. The bill proposes the range of requirements on demand deposits be from 7 to 22 percent, while the range on the other types of transactions balances would be from 3 to 12 percent. This clearly presents the possibility that actual reserve requirements will be set higher for demand deposits than for NOW accounts and share draft accounts. Yet all these types of transactions balances are functionally the same and differ only in name. There seems to be no logical reason to treat
them differently for reserve requirement purposes. We already have one indefensible distinction between demand deposits and NOW accounts; interest on demand deposits remains prohibited but is permitted on NOW accounts. Why it is “unsound” to pay interest on demand deposits, but “sound” to pay interest on the same thing under another name is beyond my comprehension. The prohibition of interest on demand deposits is a major reason for the shrinkage of demand deposits relative to the level of income and expenditures.

In 1950 business and households were willing to hold demand deposits equal to 30 percent of GNP; this ratio is now below 13 percent and still declining. If reserve requirements on demand deposits are set above those on other types of transactions balances, the tendency will be to reduce still further the growth of demand deposits.

The present set of reserve requirements for member banks, especially those applicable to demand deposits, is faulty in at least two respects. These faults are of long standing and probably cannot be corrected at this time but they should be mentioned anyway. First, these requirements are higher than necessary for monetary management purposes. Before 1936 these requirements against demand deposits ranged from 7 to 13 percent. They were raised above this level only because of two historical episodes that have no relevance to present conditions. First was the golden avalanche during the latter half of the 1930s and second was the creation of huge amounts of bank reserves during World War II as the Federal Reserve purchased Government securities to aid in financing the war. There is no longer any need for such high requirements. It is impossible to state precisely what level of requirements is necessary for monetary management. However it is certainly below present levels and is probably below 10 percent. Thus a reduction of the average level of reserve requirements could reduce the tax burden on members banks without damage to monetary management.

The second fault of the present reserve requirements is that they are graduated by the total amount of deposits in a bank. For example, present requirements against demand deposits range from 7 percent on the first $2 million of deposits to 16¼ percent on deposits in excess of $400 million. Such wide differentials can lead to slippages in the conduct of monetary policy. A net shift of deposits from banks with low requirements to banks with high requirements increases the average level of reserve requirements and tends to tighten monetary conditions whether or not that is desired. A net shift of deposits from large banks to small banks has the opposite effect. Uniform requirements for all the banks would avoid this danger.

Moreover, the present graduated reserve requirements have the effect of imposing a graduated tax on banks, with the graduation based on the volume of deposits. The graduation is not based on on net income, or the ratio of profits to capital, or benefits received, or any other criterion ordinarily employed to justify graduation. The bill before you would compound the inequity by paying only a lower rate of interest on the required reserves of large banks. As a general rule, the rate of interest paid on required reserves would be tied to the Federal Reserve’s yield on its portfolio, but the rate paid on required reserves in excess of $25 million would be limited to 2 percent. I can find no justification for this.
These faults of the existing system of reserve requirements provide the reason for my earlier statement that if only some given amount of Treasury revenue can be sacrificed to achieve reform, first priority should be given to reforming reserve requirements and only a second priority to the payment of interest on required reserves.

In conclusion, by far the most important part of this bill is that providing for the extension of federally determined reserve requirements to transactions balances created by all types of depository institutions. This reform is long overdue and urgently needed.

The CHAIRMAN. Thank you very much. Mr. Pierce.

STATEMENT OF PROF. JAMES PIERCE, ECONOMICS DEPARTMENT, UNIVERSITY OF CALIFORNIA, BERKELEY

Mr. Pierce. I appreciate the opportunity to present my views on S. 3304, a bill that imposes reserve requirements on nonmember depository institutions, that allows the Federal Reserve to pay interest on reserves and that requires the Fed to charge for its services. I agree in principle with these three reforms, yet disagree with the specific form they take in S. 3304.

S. 3304 takes the valid issues of universal reserve requirements, interest payments on reserves and charging for services, and applies them in support of a membership drive for the Federal Reserve. In the hope of attracting members to the System, the bill would impose reserve requirements on all depository institutions with transactions accounts in excess of $5 million, it would reduce reserve requirements on time deposits for member banks, and it would allow only member banks to partake of Federal Reserve services, including access to the discount window. This bill, if passed, would surely induce many nonmember banks, particularly large ones, to become members. After all, if a bank is to have required reserves imposed against it, irrespective of whether it is a member or not, it might just as well become a member and enjoy Fed services. The only additional cost would be to hold reserves against time deposits, which the bill reduces from present levels. The inducement would be particularly strong because S. 3304 would not require the Federal Reserve to charge full cost for its services. The inducement to achieve membership would also grow over time for nonbank depository institutions as growth in their transactions accounts would make low-cost Fed services and access to the discount window increasingly attractive. I see no economic rationale for encouraging Federal Reserve membership when reserve requirements are imposed on transactions accounts of all kinds of depository institutions. However, I do see an economic rationale for allowing all depository institutions access to Fed services, including the discount window, irrespective of membership in the Federal Reserve.

Membership drives for the Fed are usually defended on the grounds that the Federal Reserve needs members in order to execute monetary policy effectively. The required reserves of members put a brake on the expansion of money and credit. These requirements act to make the relationship between open market operations and the monetary aggregates more predictable. Nonmembers do not hold idle reserves with the Fed and it is often asserted that this missing link complicates monetary policy. It is further argued that nonmembers enjoy a competitive
advantage over members because they can hold much of their "reserves" in interest-bearing liquid assets. Finally, member banks have access to the discount window and nonmembers do not. As the number of member banks shrinks, the efficacy of the discount window as the ultimate source of liquidity diminishes and the "quality" of the banking system suffers.

On the surface, these arguments appear quite compelling. While there is no evidence that the erosion of membership has hindered the Fed's control over money and credit, if a large enough share of deposits is with nonmembers, presumably this control will suffer. The degree of suffering is unclear. It is crucial to note in this regard, that it is idle required reserves, not membership, that aids monetary control. The link between idle required reserves and membership in the Federal Reserve is a legal and historical one rather than an economic one. S. 3304 recognizes this distinction to a degree but then loses it. The bill would require nonmember depository institutions to hold idle reserves against their transactions accounts; they would not have to become members. From an economic point of view, transactions accounts such as NOW accounts, automatic-transfer accounts and share draft accounts, are simply demand deposits by another name. If reserve requirements on demand deposits are needed for purposes of monetary policy, then they are needed on all transactions accounts irrespective of where they reside—member bank, nonmember, savings and loan, mutual savings bank or credit union. However, the bill authorizes lower reserve requirements for transactions accounts that are not demand deposits, than it does for demand deposits themselves. This provision makes no sense to me. S. 3304 tightens monetary control through universal reserve requirements and then turns around and loosens the control through low reserve requirements for transactions accounts other than demand deposits. This loosening can be justified only in terms of maintaining or attracting members, not improving monetary policy.

With the authorization of automatic transfers from savings to checking accounts and with nationwide NOW accounts—or their equivalent—waiting in the wings there could be an explosion of nondemand deposit transaction accounts in the near future. When and if this explosion occurs, these accounts with their relatively low reserve requirements could cause much greater problems for monetary control than the gradual loss of member banks. In this bill, the Federal Reserve appears to be more interested in retaining members through low reserve requirements on these accounts than it is in maintaining monetary control. The execution of monetary policy requires the same reserve requirements for all transactions accounts irrespective of their name.

The argument that members are needed because only they have access to the discount window seems upside down to me. The discount window can be an important source of liquidity to the entire banking system. There is no reason to restrict its use to member banks. If the safety of the banking system is weakened by having a shrinking number of banks eligible to use the discount window, a simple solution is available—allow universal access to the discount window for all depository institutions offering transactions accounts that have eligible paper to discount. If universal reserve requirements are a good idea, then uni-
versal access to the discount window is even a better one. This reform would quickly solve the “quality” of the banking system problem.

I would like to comment only briefly on the provisions of S. 3304 that would require the Fed to charge for services and to pay interest on reserves. I support having the Fed charge for its services; the current system is wasteful and it inhibits competition from the private sector. I find the provisions in S. 3304 to be overly vague, however. Congress should set the guidelines for the charging system. The Fed should charge the full cost of providing all its services. The charges should include indirect costs and allowance for the cost of capital and taxes that would be paid by a private firm if it were to offer the services. The Fed should be allowed, however, to phase in the full charge system over a number of years in order to ease the transition. I believe that a market price should be charged for the discount window as well. All depository institutions with transactions accounts should have full access to Fed facilities, including the discount window and they should all pay the same prices for these services.

I am in favor of paying interest on reserves but the situation is complicated by the prohibition of payment of interest on demand deposits including correspondent balances. The case would be much stronger if explicit interest were paid on these accounts. Just as banks should receive interest on their deposits—reserves—and pay for services received from the Fed, so too should the public receive interest on its deposits and pay for services received from banks. S. 3304 provides the first half of this proposition and neglects the second.

The problem is also complicated by the current economic and budgetary situation. If the Nation were enjoying price stability and if the budget were balanced, the argument for paying interest on reserves would be compelling. Required reserves levy a sort of tax on banks. It would be much easier to have universal reserve requirement set at levels that are optimal for monetary policy, if the “tax” were eliminated. This can be accomplished by paying a market interest rate on reserves. Unfortunately, we have inflation and we have a Federal budget that is badly in deficit. In this situation, tax cuts are not easy to achieve. There have been many proposals for tax cuts in this Congress ranging from reductions in the individual and corporate income taxes to lowering the capital gains tax. I doubt that the “tax” on member banks ranks very high on anyone’s list for taxes to cut. I recommend that on this matter we follow Chairman Miller’s advice to the Congress and the President and be conservative in our tax cutting—limits the “tax” cut for banks. I suggest that this be accomplished by limiting the payment of interest on reserves to the revenue obtained by charging for Federal Reserve services including the use of the discount window.

S. 3304 is seriously flawed but it contains, I believe, the seeds of meaningful reform. I should like to conclude this testimony with a list of major revisions that I would like to see in the bill. These revisions would produce, I believe, a bill that enhances the effectiveness of monetary policy, solves the “membership problem,” increases the safety of the financial system and enhances the competitive equality among depository institutions.

1. Impose reserve requirements on transactions accounts of all insured depository institutions.
(a) Exempt the first $50 million of transactions accounts from reserve requirements.
(b) Apply the same reserve requirement to all transactions accounts including demand deposits.
(c) Impose the reserve requirement on repurchase agreements between a bank and its customers.

2. Eliminate the reserve requirements on saving and time deposits (which does not include transaction accounts).
3. Provide standby authority for the Federal Reserve to impose marginal reserve requirements on sales of large CD’s and purchases of Eurodollars by any depository institution with deposits over $100 million and on the commercial paper issued by its holding company.
4. Allow universal access of all insured depository institutions offering transactions accounts to all Federal Reserve services including the discount window.
5. Institute full charging for Federal Reserve services with the same price charge per unit of service irrespective of membership status, size, or geographic location of the depository institution.
6. Authorize the Federal Reserve to pay interest on reserves in an aggregate amount equal to the revenue from service fees and lending at the discount window. The interest rate at the discount window would be set equal to the average Federal funds rate in the previous week.

The CHAIRMAN. Thank you very much, Professor Pierce. Mr. Brown.

STATEMENT OF JON BROWN, STAFF ATTORNEY PUBLIC INTEREST RESEARCH GROUP, WASHINGTON, D.C.

Mr. Brown. Thank you, Mr. Chairman. I would like to qualify slightly your introduction, saying that all of us are distinguished economists.

The CHAIRMAN. Well, I recognize you are a distinguished attorney.

Mr. Brown. I can’t qualify for that distinction. But I would like to say that a lot of my conclusions——

The CHAIRMAN. Two out of three isn’t bad.

Mr. Brown. A lot of my conclusions arrived at independently are very similar to Mr. Pierce’s, so I don’t feel too left out.

Generally we support some provisions of S. 3304, but feel that other provisions are unnecessary, and feel that there is a need for additional provisions and further study.

We think that the concept of universal reserve requirements makes sense, and we endorse that provision of the bill, although we are not sure at this time it is necessary to extend it to the thrift institutions.

On the other hand, we think if you have universal reserve requirements, that resolves at least for the moment the membership problem. In fact, it makes the membership problem moot, and therefore the payment of interest on reserves is not necessary, as a means to deal with the membership problem.

We believe that the payment of interest on reserves is fundamentally a question of Federal tax policy, and as such it should be dealt with by Congress and really should not be dealt with by the Federal Reserve Board.
The Federal Reserve Board has ample to do in the area of monetary policy, without having additional responsibilities in fiscal policy. We believe that there are several unanswered and unexplored areas, which should be looked at further before any bill is finally reported.

The first area involves needed reform of the Federal Reserve banks themselves to end the dominance of the banks by their commercial banking members. This, in the past, has been one of the primary functions of the Federal Reserve System membership and is part of the overall review of the membership role that should be looked into.

Second, we think there is a need to further examine whether or not there is any great public benefit in having a supervisory role for the Federal Reserve Board, and it should be freed from its supervisory responsibility and concentrate more on monetary policy.

We think these two additional questions are very relevant now, because for once, and on very rare occasions this has happened, Congress has some leverage over the Federal Reserve Board, when they feel there is something wrong and are coming to Congress and asking for assistance. Before that assistance is granted, we think it is time to take a hard look at whether or not there are not changes needed in the Federal Reserve System.

I won’t read the testimony. I will comment briefly or take brief excerpts from it.

The first is to point out that many of the Federal Reserve Board’s claims about the adverse impact of declining membership are clearly self-serving and should be viewed with considerable skepticism. The reason for the fact that they are self-serving is obvious, and that is that the size of System membership is a measure of the political power base of the Federal Reserve Board, and the Reserve Board has a very strong interest in increasing or at least maintaining the size of its membership.

But nonetheless, even though we feel these claims should be viewed with skepticism, we think there are substantial reasons for legislative revision of the current structure of System membership.

First of all, we feel it is sound policy to diverse reserve requirements from System membership, and that is what universal reserves would do.

Tying reserve requirements to System membership results in an unfortunate intertwining of the issue of reserve requirements with the size of the Federal Reserve Board’s political power base. Empowering the Board to impose reserve requirements on all commercial banks, regardless of whether they are system members, avoids this problem. It also eliminates the need to pay interest on required reserves as a means to entice banks to join or remain System members.

Moreover, if adjustment of reserve requirements is, in fact, a useful monetary policy tool, a Federal Reserve Board claim that runs counter to most independent research on this issue, then divorcing reserve requirements from System membership will allow the Board to adjust reserve requirements without worrying about inducing changes in System membership.

Universal reserve requirements for all commercial banks would eliminate the role of the States in establishing reserve requirements. However, this aspect of the dual banking system does not serve any great public purpose and its loss would be a small price to pay for re-
solving the competitive equity problem and possibly improving the
conduct of monetary policy.

All depository institutions, including savings and loans, mutual
savings banks, and credit unions, whether System members or not,
should have access to the Federal Reserve discount window and to Fed­
eral Reserve services. No public purpose is served by limiting access
to System members.

Service charges should be imposed on all users of Federal Reserve
services. Such explicit pricing would result in more efficient use of
these services. Moreover, if all depository institutions have access to
these services, not just System members, then the Federal Reserve
Board will not be tempted to underprice its services for the purpose
of increasing System membership, although other incentives for such
underpricing would remain.

If Federal Reserve Board reserve requirements were imposed on all
commercial banks, then there would be no pressing need to pay inter­
est on required reserves. Under this approach sterile reserves would
represent a tax on commercial banks.

As I indicated before, the need and the appropriate size of that tax
is a matter for congressional determination and should not be dele­
gated to the Federal Reserve Board.

Once reserve requirements, access to the discount window, and ac­
cess to Federal Reserve services are divorced from System membership,
the apparatus of System membership under which System members
hold voting stock in the 12 Federal Reserve Banks and elect two-thirds
of the nine directors of each Federal Reserve Bank serves no public
purpose. In this situation System membership would merely identify
those State-chartered banks that choose to be supervised by the Fed­
eral Reserve Board, if a continuing Federal Reserve Board role as a
supervisor is found desirable.

Commercial bank ownership and more important, control of the
Federal Reserve Banks, biases these institutions in regard to monetary
policy in favor of commercial banks and their large corporate cus­
tomers and represents a gross conflict of interest in regard to their
supervisory responsibilities. Thus, it is essential that any genuine solu­
tion to the Federal Reserve membership problem remedy this under­
living bias and conflict of interest. To accomplish this, the stock in
the Federal Reserve Banks should be retired and the Banks trans­
formed from quasi governmental entities to administrative divisions
of the Federal Reserve Board. The Reserve Banks’ boards of directors
should be abolished and their Presidents appointed by either the Presi­
dent of the United States, with Senate confirmation, or by the Board
of Governors.

Reforming the structure of the Federal Reserve Banks, however,
does not resolve the question of whether it is appropriate for a central
bank such as the Federal Reserve, to have major bank supervision re­
sponsibilities. There are certain characteristics inherent in a central
bank that are antagonistic to bank supervision in the public interest.
In selecting Governors for the Federal Reserve Board, an important
criterion is maintaining business confidence, and thus the Board has
an unavoidable bias in favor of large corporations and the banking
industry. The interests of consumers, labor, and minority groups re­
cieve less attention. As a central bank, the Federal Reserve is domi-
nated by a large staff that is oriented toward highly technical economic and monetary analysis and lacks a broad perspective on issues of equity, such as civil rights, consumer affairs, community reinvestment, and displacement.

Finally, as a central bank, the Federal Reserve has developed a strong policy of operating in secrecy. This policy goes far beyond that appropriate for bank supervision and unnecessarily impedes both congressional oversight of bank supervision issues and citizen participation.

Although the performance of all the Federal banking agencies in the areas of consumer protection, civil rights, and community reinvestment is not satisfactory, the Federal Reserve Board’s is certainly the worst. The most dramatic evidence of this is the Board’s failure to develop an effective data collection system for enforcement of the fair housing laws and its current efforts to undermine the Community Reinvestment Act.

Thus, from the perspective of consumers, minorities, and neighborhood residents, bank supervision would be improved if the supervisory role of the Federal Reserve Board were eliminated. This would also enable the Board to devote more time to the conduct of monetary policy.

Now I realize that there are counterarguments, arguing that the Federal Reserve actually is more effective in implementing monetary policy if it has some base as a bank supervisor.

One of the arguments made is the Federal Reserve can hold approval of bank holding company applications as a club to get the banks to not extend their activities in the Eurodollar market, during periods when the Federal Reserve Board was trying to limit the money supply. However, I think these claims should warrant much further investigation before they are taken at face value.

They also raise serious questions as to the tradeoff between monetary policy and approval of applications is really in the public interest, or whether or not each supervisor or regulatory function should be out in the open and should not be tied to performance in other areas.

I also would like to comment just briefly on our strong feeling that in terms of implementation of the Community Reinvestment Act, the Federal Reserve has played a very negative role in that. The best evidence of that occurred yesterday when the Federal Reserve Board denied a petition for reconsideration filed by a community organization protesting a bank holding company application. I attended that meeting, and I was very shocked by the presentation made by the Board staff to the Board of Governors. Because the presentation indicated several things, one, that the Board staff views the language in the Community Reinvestment Act as basically a nullity, and that the affirmative obligation standard set out in the act, they feel is merely a preamble, and has no legal effect.

I also was somewhat shocked to find the staff is making misstatements of fact, and distorting the record in answering questions presented to them by the Board of Governors.

So I think there are serious problems here, and this is one of the main reasons why we feel that ending the Federal Reserve Board’s supervisory role would be beneficial.

Thank you.
Statement of Jon Brown, Staff Attorney, Public Interest Research Group

My name is Jonathan Brown. I am a Staff Attorney with the Public Interest Research Group, a Ralph Nader organization. My principal assignment is to monitor the Federal banking agencies.

S. 3304, the Federal Reserve Requirements Act of 1978, would authorize the Federal Reserve Board to impose reserve requirements on transaction accounts of all depository institutions and to pay interest on required reserve balances. The bill would also require the Federal Reserve Board to establish fees for its services. This legislation has been introduced and is being considered at this time because of the Federal Reserve Board's insistent protestations that declining System membership undercuts both effective implementation of monetary policy and sound bank supervision. To some extent, the Federal Reserve Board views universal reserve requirements and payment of interest on reserves as alternative solutions to the problem of declining membership.

More specifically, the Federal Reserve Board claims that declining System membership undercuts the Board's ability to control the money supply, reduces access to the discount window, and weakens the payments system. The Federal Reserve Board also alleges that the resulting decline in its supervisory role indirectly weakens its ability to implement monetary policy.

Since System member banks provide the Federal Reserve Board with its political power base, the Board's claims concerning the adverse effects of declining membership are clearly self-serving and must be viewed with considerable skepticism. Nonetheless, there are substantial reasons for a legislative revision of the current structure of System membership.

First, it is sound public policy to divorce reserve requirements from System membership. Tying reserve requirements to System membership results in an unfortunate intertwining of the issue of reserve requirements with the size of the Federal Reserve Board's political power base. Empowering the Board to impose reserve requirements on all commercial banks, regardless of whether they are System members, avoids this problem. It also eliminates the need to pay interest on required reserves as a means to entice banks to join or remain System members. Moreover, if adjustment of reserve requirements is in fact a useful monetary policy tool, a Federal Reserve Board claim that runs counter to most independent research on this issue, then divorcing reserve requirements from System membership will allow the Board to adjust reserve requirements without worrying about inducing changes in System membership. "Universal" reserve requirements for all commercial banks would eliminate the role of the states in establishing reserve requirements. However, this aspect of the dual banking system does not serve any great public purpose and its loss would be a small price to pay for resolving the competitive equity problem and possibly improving the conduct of monetary policy.

All depository institutions, including savings and loans, mutual savings banks, and credit unions, whether System members or not, should have access to the Federal Reserve discount window and to Federal Reserve services. No public purpose is served by limiting access to System members. Service charges should be imposed on all users of Federal Reserve services. Such explicit pricing would result in more efficient use of these services. Moreover, if all depository institutions have access to these services, not just System members, then the Federal Reserve Board will not be tempted to underprice its services for the purpose of increasing system membership, although other incentives would remain.

If Federal Reserve Board reserve requirements were imposed on all commercial banks, then there would be no pressing need to pay interest on required reserves. Under this approach sterile reserves would represent a tax on commercial banks. Whether this tax is appropriate and to what extent it would be reduced or eliminated is a question for Congress to decide, not the Federal Reserve Board.

Once reserve requirements, access to the discount window, and access to Federal Reserve services are divorced from System membership the apparatus of System membership under which System members hold voting stock in the 12 Federal Reserve Banks and elect two-thirds of the nine directors of each Federal Reserve Bank serves no public purpose. In this situation, system membership would merely identify those state chartered banks that choose to be supervised by the...
Federal Reserve Board—if a continuing Federal Reserve Board role as a supervisor is found desirable.

Commercial bank ownership and more important control of the Federal Reserve Banks biases these institutions in regard to monetary policy in favor of commercial banks and their large corporate customers and represents a gross conflict of interest in regard to their supervisory functions. Thus, it is essential that any genuine solution to the Federal Reserve membership problem remedy this underlying bias and conflict of interest. To accomplish this the stock in the Federal Reserve Banks should be retired and the Banks transformed from quasi governmental entities to administrative divisions of the Federal Reserve Board. The Reserve Banks' boards of directors should be abolished and their Presidents appointed by either the President of the United States, with Senate confirmation, or by the Board of Governors.

Reforming the structure of the Federal Reserve Banks, however, does not resolve the question of whether it is appropriate for a central bank such as the Federal Reserve to have major bank supervision responsibilities. There are certain characteristics inherent in a central bank that are antagonistic to bank supervision in the public interest. In selecting Governors for the Federal Reserve Board an important criterion is maintaining business confidence, and thus the Board has an unavoidable bias in favor of large corporations and the banking industry. The interests of consumers, labor, and minority groups receive less attention. As a central bank, the Federal Reserve is dominated by a large staff that is oriented toward highly technical economic and monetary analysis and lacks a broad perspective on issues of equity, such as civil rights, consumer affairs, community reinvestment and displacement. Finally, as a central bank the Federal Reserve has developed a strong policy of operating in secrecy. This policy goes far beyond that appropriate for bank supervision and unnecessarily impedes both Congressional oversight of bank supervision issues and citizen participation.

Although the performance of all the federal banking agencies in the areas of consumer protection, civil rights, and community reinvestment is not satisfactory, the Federal Reserve Board’s is certainly the worst. The most dramatic evidence of this is the Board’s failure to develop an effective data collection system for enforcement of the Fair Housing laws and its current efforts to undermine the Community Reinvestment Act. Thus, from the perspective of consumers, minorities, and neighborhood residents, bank supervision would be improved if the supervisory role of the Federal Reserve Board were eliminated. This would also enable the Board to devote more time to the conduct of monetary policy.

The Chairman. Well, thank you very much. This has been a very interesting panel. I think it is useful to have a public interest attorney mixed up with economists every now and then. I think the panel this morning establishes that.

Before I start with questions, I would like to suggest that one way we might consider going—as kind of a first step—is first universal reserve requirements, with exemptions, and nobody seems to really be very much opposed to that. The Federal Reserve Board, the Treasury has that as a first choice, the Federal Reserve Board suggested an alternative way of following that.

Actually the banks would, on the basis of either the Federal Reserve Board’s proposal or the Reuss proposal, in the aggregate at least, have their earnings improved.

So that is a practical possibility.

Second, charging for all services to everybody equally. Permitting the big banks who want to compete with the Federal Reserve to come in, encourage them to come in, and provide, in my way of thinking, a constructive competitive atmosphere that would be to the public’s advantage. That is, not only charging for Federal Reserve Board services, but correspondent banking services, making the whole system fully competitive that way.

Third, as Professor Pierce argued, I thought so tellingly, access by all depositors to the discount window, which, incidentally, combined
with the second point I made would tend to eliminate a major reason for being a member of the Fed. Universal reserve requirements would mean membership wouldn’t be necessary anyway as far as monetary policy is concerned.

And, finally, following all of this up along the same line, eliminating the prohibition against interest on demand deposits.

It would seem if we can achieve those ends in the next few years, we would have a more competitive dynamic, efficient, and equitable banking system than we have now.

Professor Chandler, several witnesses have argued that membership as such in the Federal Reserve is not necessary for the Federal Reserve to carry out the functions of a central bank. Do you agree?

Mr. CHANDLER. I think the question of membership is of minimum importance. The question is what kinds of reserve requirements are applicable to all banks, and the access to the discount window. Those are two important things. If you can achieve those without membership, then I have lost all interest in the membership question.

The CHAIRMAN. On the other hand, if you do not have universal reserve requirements, membership then becomes significant. If we didn’t change anything, if we permitted the present situation to continue, with the notion of membership in the Federal Reserve continuing as the Federal Reserve Chairman argues it is, do you think that would have an adverse effect on effective monetary policy?

Mr. CHANDLER. That is a serious question, because a larger and larger part of the bank resources would be outside of the system, and not subject to reserve requirements. That is the major difficulty. There are all sorts of political arguments that are made about the Federal Reserve’s political base, that sort of thing, to which I attach almost no importance. Perhaps they do.

But to me the question of what instruments are available for what purposes is far more important than Fed membership.

The CHAIRMAN. I would like to ask both you and Mr. Pierce, you are both highly respected monetary economists, and both of you are in favor of universal reserve requirements, at least for transaction accounts, as I understand it.

Both of you said such universal reserves would enhance monetary management. You say this even though there is no empirical evidence to support the claim that the attrition of membership has materially damaged monetary policy.

So I would like to hear your reasoning for the conclusion that uniform reserve requirements would be a desirable way to enhance monetary management and solve the membership issue. Dr. Pierce, why don’t you go first.

Mr. PIERCE. Your assertion is correct. So far as I know, there is no empirical evidence to support the claim that the attrition of membership has materially damaged monetary policy.

There are two reasons that membership as now constituted is important. There is empirical evidence to suggest that shifts of deposits among different sizes of banks that are members does have an effect on the predictability of the relationship between open market operations and money and credit. The issue is “Can the Fed figure out what the effect of its monetary policy will be on money and credit?”
The reasons for the Rube Goldberg reserve requirements we have now is to attract and retain members. Great efforts were expended to try to give a menu of reserve requirements to keep banks in the system. Shifts of deposits among classes of banks that are members do cause problems. Not large problems, but they cause problems in predictability.

The second point I want to make is that as a larger and larger share of the deposits are outside of the Federal Reserve System, then the likelihood that the relationship between open market operations and money and credit expansion will become less and less predictable. I can't prove the assertion empirically, but theoretically one can show that that is the case. I think commonsense just says that as well. Loss of reserves through membership attrition is the functional equivalent of a very large reduction in reserve requirements. The function of reserve requirements is to put a brake on expansion of money and credit in the economy. As we have more and more deposits outside of the banking system, then effectively the reserve requirements for the whole banking system are lowered as a result of that. And the relationships are less predictable.

The CHAIRMAN. On the other hand, if you make them comprehensive and universal, you can have lower reserve requirements, isn't that true?

Mr. PIERCE. Yes, and no. I am troubled by what I view to be contradictory parts of what the Federal Reserve may do.

We need reserve requirements to make that relationship between the open market operations and money and credit more predictable. But the lower the reserve requirements are, even though universal, the less predictable the relationship will be anyway.

The CHAIRMAN. I am not saying you can eliminate them or have tiny reserve requirements. I am saying that they can be reduced if they are universal, and then you have two things: (a) you have equity, and (b) you have a more effective monetary system at any given level of reserves. Obviously therefore you can get the same effect with a somewhat lower reserve requirement.

Mr. PIERCE. I think so, although I am not certain of that. That is certainly not a theorem. It is possible that you will get more predictable relationships with universal reserve requirements, but lower requirements—

The CHAIRMAN. How predictable does your monetary policy have to be? It is not very predictable. We get the chairman to come up and Arthur Burns, who was a brilliant economist, and Chairman Miller, who is a highly competent man come up and they are way off. They can never come anywhere near their estimates of what the increase in the monetary aggregates are going to be. They are about as far off as they can get.

Mr. PIERCE. My short answer is not very important.

The CHAIRMAN. OK, it is not very important.

Mr. PIERCE. I think that is right. Of all of the problems facing monetary policy, figuring out what to do and how to do it, the kind of predictability I have been discussing is not very high on the list. It is a factor, and I think that if one can do something to make monetary policy more easy to conduct, then one should.

Let me add just one point. I am afraid something may get lost in the bills being proposed now, not S. 3304, but in the Reuss bill, for example, which addresses only commercial banks. For monetary con-
trol, one has to talk about all transactions accounts. Universal reserve requirements really have to be universal with respect to all transactions accounts, no matter where they are.

The CHAIRMAN. We are talking about universal reserve requirements with an exemption.

Mr. PIERCE. An exemption is OK, but what I mean is that thrift institutions must be included. Right now their exclusion is not an important problem. But it won’t be many years before transactions accounts at thrift institutions are very big.

The CHAIRMAN. Every witness has said that, as far as transactions accounts are concerned, including the witness representing the thrift institutions himself. He recognized that they had to have that for transactions accounts.

Mr. PIERCE. I am concerned that point will get lost. I think that it would be very unfortunate if one waits until we have these accounts and then tries to impose reserve requirements. Politically I think that will be very difficult, it is a lot easier to do it now.

The CHAIRMAN. Dr. Chandler?

Mr. CHANDLER. I see no objection to having an exemption of a certain minimum amount from reserve requirements, or zero reserve requirements for another certain minimum. But I have heard people talking about setting that at $100 million per bank or financial institution. That strikes me as being clearly excessive.

The CHAIRMAN. $100 million for both demand and time deposits. That was the House Chairman’s proposal.

Mr. CHANDLER. OK. But the main point I want to make is if you set them that high—

The CHAIRMAN. The Fed was $25 million and $25 million and a total amount Chairman Reuss suggested was $100 million.

Mr. CHANDLER. Yes. Even if it is total demand plus time plus securities sold to customers under repurchase and so on, that is getting up to a pretty good sized bank.

The CHAIRMAN. The first $100 million would be exempt, so you wouldn’t have a cutoff period, where all of a sudden you covered all of your deposits.

Mr. CHANDLER. Suppose we take $100 million total deposit liabilities, with everything below that exempt, then you have a real possibility here of large net shifts of funds from institutions subject to positive reserve requirements, to zero or from zero to positive.

The CHAIRMAN. Well, yes, and we are aware of that; in fact Chairman Miller suggested that we make sure that we have in the legislation prohibitions against being able to have a holding company divide up into nothing but $100 million institutions.

Mr. CHANDLER. That is not the danger that I was referring to, although it is real.

The CHAIRMAN. I see your point.

Mr. CHANDLER. You still get $1 million net shift from banks with a positive reserve requirement of 7 percent to banks with a zero requirement, or vice versa.

The CHAIRMAN. Your contention is not we shouldn’t have exemptions but it should not be as high as $100 million?

Mr. CHANDLER. Something below half of that, it seems to me, would probably not only be acceptable, but would have a lot of political advantages anyway.
But I would warn against raising that level too high.

The Chairman. I would like to hear your reasoning for your conclusion that the uniform reserve requirement would be a desirable way to enhance monetary management and solve the membership issue.

That was my fundamental question, which you haven't answered yet.

Mr. Chandler. If the exemption were set low enough, so very large amounts of funds could not be shifted from positive reserve requirements to zero, then at the margin you could have uniform level of reserve requirements against transactions accounts, which ought to give you a more or less constant multiplier between the reserve base and the monetary magnitudes.

The Chairman. You said reserve requirements should be lowered, and that would reduce the cost of idle reserves. The question I have is how low can reserve requirements be and still be a useful monetary tool? Also, is there a need for reserves against time and savings deposits or do you agree with Professor Pierce that reserves against such deposits could be zero?

Mr. Chandler. I think both he and I would have trouble being dogmatic on that one.

The Chairman. Start with the first one, how low can reserve requirements be and still be a useful monetary tool?

Mr. Chandler. On transactions balances?

The Chairman. Yes.

Mr. Chandler. Somewhere below 10 percent, I would say in the range of say 7 to 10 percent. That is fairly arbitrary.

The Chairman. That is fairly close to what the Federal Reserve said 7 and 9 percent. Chairman Reuss said 6 percent. Do you think that is too low?

Mr. Chandler. I have no way of saying it is too low. As you get to lower levels, you run into the danger that the legal reserve requirements will at certain times be below what the banks want to hold for prudent purposes.

I would always like to have the legal reserve requirement high enough so that at least most of the time it would be higher than what the banks would elect to hold voluntarily. So that in fact you do get a solid base on which to operate.

The Chairman. Professor Pierce, I would like you to comment on Mr. Brown's very interesting charge against the Federal Reserve. It is one that I think an expert like you, who is very familiar with the responsibilities of the Federal Reserve, can give us some help on.

He argues that the Federal Reserve tends to overlook the interests of consumers, labor, minority groups, and so forth, and here is what he says, and I quote:

As a central bank, the Federal Reserve is dominated by a large staff that is oriented toward highly technical economic and monetary analysis and lacks a broad perspective on issues of equity, such as civil rights, consumer affairs, community reinvestment, and displacement. Finally, as a central bank, the Federal Reserve has developed a strong policy of operating in secrecy. This policy goes far beyond what is appropriate for bank supervision and unnecessarily impedes both congressional oversight of bank supervision issues and citizen participation.
I think that is a rather gentle criticism, as a matter of fact. He could have been sharper than that, and pointed out that the Federal Reserve, of course, has its constituency among bankers. Very often the people who are appointed to it are former bankers, and the Open Market Committee, one of the principal policymaking arms, is composed very largely of bankers.

So that that tends to reinforce the criticism Mr. Brown makes. What do you think of that?

Mr. Pierce. First, I agree that Mr. Brown's criticisms were delicately and nicely put. I also agree with them, with one exception. The Federal Reserve does have a very large staff and a very good one. But it has a very large number of people who are assigned to the very problems that he described. Not all of the staff concerns itself with monetary policy. There are hundreds of people who worry about regulatory questions at the Federal Reserve, both at the district banks and the Federal Reserve Board.

The problem is not that the Fed is overwhelmed by the specialists who concern themselves with monetary policy, but rather that the Fed’s first interest is in monetary policy, and I think very often it views these regulatory questions as a pain. I think the Fed believes very strongly it should be in the regulatory business, and has certainly testified to that effect, but one hears complaints, I understand you have heard them yourself, from former members of the Fed that too much time is spent on regulatory questions relative to monetary policy.

These complaints are indicative of the attitude of the Federal Reserve. It would rather be doing something else than worrying about whether the statutes Mr. Brown referred to are being enforced in the spirit in which Congress passed them. I think there is really no way to solve that dilemma without really having the Fed get out of a lot of regulatory areas. There is a conflict. I don’t think these are people who want to flaunt the Congress, but rather that it is viewed as a pain, to have to do these things.

Well, one can remove that pain by giving some of those responsibilities to agencies that view it as their function and their duty to enforce these laws with great vigor.

So I agree basically with what Mr. Brown said.

The Chairman. Let me ask you further about the issue of secrecy. David Lilly, who was a Governor of the Federal Reserve Board, wrote me last year, and said:

I see no reason why the release of the policy directive of the OMO needs to be delayed. Everyone should have the same access to the decisions made by the OMC.

Currently, only those brokers and dealers with large staffs monitoring Federal Reserve policy on a daily, and in some cases hourly basis can know what monetary policies the OMC is pursuing. This is discriminatory and gives brokers and dealers advantage over the ordinary citizen.

Mr. Pierce. I agree with that. The brokers and dealers, or dealers, I would say, all have staffs that are Fed watchers. It is a matter of hours, probably minutes, before they have figured out that the Fed has changed the intervention point with respect to the Federal funds rate. The general public doesn’t know about a change in policy for 30 days. Now I see no reason to keep the general public in the dark. The secrecy does not achieve what it is intended to achieve, namely, to hide from the market what the Fed is up to. I have never understood why
the central bank finds it in its interest to try to fool the public by not disclosing immediately what it is up to. But be that as it may, it doesn't even accomplish that goal, because the dealers are able to figure out quickly when the Fed changes policy.

After all, the Fed changes policy by buying and selling securities from those very dealers, so it is not very difficult for them to figure out when the Fed has changed policy. So I agree with Mr. Lilly's position.

The CHAIRMAN. Mr. Chandler?

Mr. CHANDLER. I think there is every reason why they should make public the policy statement 24 or 48 hours later, whatever time it takes to prepare it. I see no reason to withhold it.

On the other hand, I do think that the Board should have privacy in arriving at its policy decision. I think that the presence of large numbers of people at the meeting, or even a few who will do a lot of talking, would tend to inhibit discussion, frank statements of views, and that sort of thing.

But they should make their policy statement public say 48 hours after they arrive at it. That seems perfectly reasonable and desirable.

The CHAIRMAN. Mr. Brown, last February, as I said, former Governor Lilly wrote me after he left the Federal Reserve Board, and he indicated ways in which he thought the system could be improved. Those included changes in appointment of Federal Reserve Boards of Directors, and he said:

Only the three class C directors are chosen by the Board of Governors. The class A and B directors are chosen by the member banks. This ostensibly gives the member banks a larger voice in the running of the Reserve banks than the Board of Governors. In light of the reforms made with regard to the interests to be represented by members of the Board of Directors made by Public Law 95-188, I believe it would be desirable to have both class B and class C directors selected by the Board of Governors in Washington.

Do you have any views on that?

Mr. BROWN. That would definitely be a modest improvement over the current situation. You have two-thirds of the directors selected by the Federal Reserve Board, which are Presidentially appointed members. But I think it doesn't deal with the underlying problem, and that is why should there be any directors who are elected by the banking industry, when in fact those banks regulate the banking industry?

I think it is analogous to allowing the oil companies to elect members to the Federal Power Commission, or the airlines to elect members to the CAB. It just stands contrary to the sound principles of regulatory administration. I think it is an anachronism that grew out of the formation of the Federal Reserve System, the idea that the banks would be a cooperative venture on the part of the commercial banks that comprise that district, they would buy stock in the Federal Reserve banks, and therefore they would have ownership and should have voting rights.

I think we have long passed the stage where there is a need to view the Federal Reserve banks as a cooperative endeavor with commercial banks.

I think the Federal Reserve banks should be administrative subdivisions of the Federal Reserve Board and the stock of the commercial banks should be retired and the board of directors abolished outright. I don't think they serve any legitimate function, other than advisory. President Carter and many others have raised a lot of questions about
the value of advisory committees, the way they have been handled in most agencies.

The CHAIRMAN. Senator Sarbanes. I might say Senator Sarbanes sat at Professor Chandler's feet a few years ago at Princeton, and it is good to see a professor having to sit at the feet of his former pupil.

Senator SARBAKES. Mr. Chairman, I am not going to carry that analogy very far. I have no questions, I really just came to pay my respects to Professor Chandler from whom I feel I have learned a great deal. I am not sure how often my colleagues here agree with that, but I am pleased to welcome him today.

Mr. CHANDLER. Mr. Chairman, might I make a comment on one proposal, to which I am absolutely opposed, and that is that the presidents of the Reserve banks be appointed by the President with the advice and consent of the Senate.

I think monetary policy responsibility should be concentrated in the Board of Governors, and there should not be another competing group of people out there claiming Presidential and congressional approval, who would then divide responsibility and shift it around.

I am all for anything that will concentrate responsibility in the Board of Governors; as far as I am concerned, you can abolish the boards of directors of the individual Reserve banks if you want to, it would be very little loss, anyway, but this business of having a Board of Governors in Washington and 12 Presidential appointees out in the various Reserve banks makes no administrative sense whatever.

The CHAIRMAN. When it comes to the fundamental instrument of monetary policy, open market operations, you have the Open Market Committee, which has five of its members selected, as I understand it, from the Reserve presidents, who are appointed by the—

Mr. CHANDLER. You should concentrate responsibility for open market operations in the Board of Governors.

The CHAIRMAN. Have the seven members of the Federal Reserve Board determine open market policy instead of the 12?

Mr. CHANDLER. I think that would be better.

I know something about the history of the Federal Reserve, in the days before power came to be concentrated in the Federal Reserve Board, and I can tell you that was a disgraceful history as the 12 presidents upset the applecart time after time. I don't want to see a repetition of that.

Mr. PIERCE. Mr. Chairman, I agree with Professor Chandler. I just want to make one additional point, or argument in favor of what he proposed. Namely, I know there has been a lot of discussion of having the Federal Reserve Bank presidents appointed by the President and confirmed by the Senate. Since they sit on the FOMC, that seems somehow appropriate, in fact, it has been argued that the configuration is unconstitutional. Be that as it may, I want to warn you that one doesn't buy very much by such an arrangement. While it is an improvement to have the bank presidents appointed by the President, the reason you are not buying very much with that reform is the Federal Reserve Board approves the budget of the Federal Reserve Banks. It is extremely difficult for a Federal Reserve Bank president to be very independent, if he knows that if he goes too far from what the Board of Governors would like him to do, he can have his budget cut.
It is very detailed control the Federal Reserve Board has over the Federal Reserve banks. They are not free agents, and I don't think they should be treated as such and accorded a Presidential appointment and think somehow we have 12 people out there representing different parts of the country. Such an arrangement wouldn't work as long as the Federal Reserve Board has budgetary control over the Reserve banks. I can't figure any way to eliminate that control.

The Chairman. You can't eliminate it. You could give Congress control over the Federal Reserve budget.

Mr. Pierce. You could do that.

The Chairman. They should have it.

Mr. Pierce. But that is a separate issue, I agree with that, but it is a separate issue. I think the easiest solution is to do what Professor Chandler recommended, simply to have the FOMC composed of Board members and not to have the current arrangement in which the Board sets reserve requirements and the FOMC makes open market operation decisions. Rather, there should be one group of people who make monetary decisions, and that that group should be in Washington, and it should be the Federal Reserve Board, period.

The Chairman. One role played by reserve requirements that are imposed by the Federal Reserve is as clearing balances through which transfers are made. In effect they are a type of demand deposit and collections are cleared against them.

Viewed in this manner, wouldn't it be most useful to consider interest on reserves, when the subject of interest on demand deposits is discussed, not as a separate issue? I think we would have a better and more dynamic system if we permitted interest on demand deposits. Mr. Pierce?

Mr. Pierce. I think they are analogous. I raised that point in my testimony. I agree that if the Fed is going to pay interest on reserves and charge for services, I think it is appropriate that the banks do the same thing with respect to their customers. And to separate those two parts would be a mistake. One ought to buy something with the payment of interest on reserves.

The Chairman. Dr. Chandler, before you answer, let me just say that we talked a lot and the bankers are very sensitive to the fact that they have to sterile part of their earning assets in effect by putting them in reserves, which don't give them any return. At the same time they benefit in a sense from the fact that they have enormous amounts of demand deposits, usually greatly exceeding their reserves, on which they pay no interest.

So why wouldn't it be sensible, if we are going to permit interest on reserves, to have interest on demand deposits considered at the same time?

Mr. Chandler. There has never been a decent case against payment of interest on demand deposits. They came in under false pretenses.

The Chairman. That was in the beginning of the depression?

Mr. Chandler. They came in in 1933, in the Banking Act of 1933, when everybody's attention was devoted to opening the banks, and this went in without debate. It had been opposed the preceding year when it was in the Banking Act of 1932, and didn't get through at that time, but it slid through with everything else in 1933.
The Chairman. So if we pay interest on reserves and don't permit interest to be paid on demand deposits, the banks would really be having their cake and eating it, too. It would seem, from the standpoint of the taxpayers that they lose in interest on demand deposits, and save in no interest on reserves.

Mr. Chandler. I can argue the Treasury is paying through the nose on this. The public is willing to hold demand deposits now equal to only 13 percent of GNP whereas it was 30 percent in 1950. So households and business firms have found all sorts of ways of economizing on demand deposits, not only by holding savings and time deposits, but all of the other liquid assets you can think of.

This has lowered the volume of deposits, cut down the amount of securities held by the Federal Reserve, below what it would have been otherwise, and costs the Treasury hundreds of millions of dollars a year.

I think that is one of the least objections to the prohibition on demand deposits, but it is one.

The Chairman. You have an interesting confusion of what transactions accounts are, because the whole thing is so dynamic. You both mentioned automatic transfer from savings to checking accounts, that will be permitted after November 1, 1978. This new bank service would definitely give savings accounts, at least a portion of savings accounts, the characteristics of a transactions account as defined in S.3304.

How should the question of reserves against transaction accounts in automatic transfers be handled? Should, for example, a new category of deposits called transaction savings be defined, with special characteristics? You are shaking your head.

Mr. Pierce. They are a checking account with another name. Whatever reserve requirement is appropriate for conventional checking accounts is also appropriate for the same thing with a different name, with automatic transfer or NOW accounts, or whatever.

I would add that we are having this proliferation of these strange accounts precisely because of the prohibition against payment of interest on demand deposits. This problem would disappear if interest were simply paid. It wouldn't be necessary to dream up these clever ruses that the lawyers say render an account not a demand deposit, when the economics makes it a demand deposit.

Mr. Chandler. I might add to that that even if you say that these savings accounts automatically transferable to demand are demand deposits, which you should, you are still going to have, with this electronic funds transfer system developing, all sorts of new ways of making shifts among these different assets, quickly and very cheaply, so that you are just going to have to watch this as the years go by and recognize you will probably be two steps behind all of the time. Because a lot of very clever people with highpowered computers can do almost anything of this sort.

The Chairman. Senator Sarbanes?

Senator Sarbanes. I am sure this question has already been addressed, because I know the substance of it is in both of your statements. But if we were to rationalize the reserve requirement both in terms of to what accounts it should apply and the level of the re-
quirement, what is the argument for paying interest on such revenues instead of simply requiring them as, in effect, a condition of being the banking business?

Mr. Pierce. Requiring the banks to take a certain amount of their assets and hold them in noninterest bearing form is equivalent to a tax.

The rationale for requiring banks to hold these funds idle is for purposes of monetary policy. But it is costly to the banks in the sense that they could have earned interest on the funds if they had invested them in the market.

I think as a matter of public policy, if a certain group is singled out to act differently than it otherwise would, in the interest of public policy, that group should be compensated.

Senator Sarbanes. Except the banks have an interest in a properly functioning monetary system.

Mr. Pierce. No more than you or I. The banks just happen to be the vehicle. I am as interested in that as the banks are and I would object if you passed a law saying I had to put a certain amount of my money aside and not earn interest on it. I don’t think their interest is any greater with respect to the stability of the economy than anyone else’s, or any less.

No, I don’t think one can argue that. And furthermore, ou get perverse reactions——

Senator Sarbanes. Why don’t other countries pay it? Our study shows that hardly any other major developed country pays interest on the reserve requirement.

Mr. Pierce. Professor Chandler can answer that better than I can. Very few countries have idle reserves, Senator, which I think helps explain why that is true. You can hold them in Treasury bills, and that is no problem.

Mr. Chandler. There is no problem if they hold them in Treasury bills, but it doesn’t do any good either.

Mr. Pierce. That is right. It is a nonissue if, as in other countries, the banks are allowed to hold the reserves in the form of, say, government securities. Then you lose the whole function of reserves as a brake on expansion of money and credit.

We do it differently, we say hold that money idle, because it gives us a more predictable monetary policy instrument. That is fine, I agree, but it injures bank profits, it causes the membership problem. Why be a member bank if you can be a nonmember——

Senator Sarbanes. You wouldn’t have a choice as to whether you would be a member so far as reserves are required. It would be a requirement. Why should the system operate in such a way that the banks can choose to opt out of the operation of monetary policy?

What is the rationale for that?

Mr. Pierce. None. But the reason that it is an issue is because it is costly for banks to have required reserves. For monetary policy it is needed. We need universal reserve requirements. But then there is the issue of does Congress want to tax banks in that way.

The Chairman. We don’t tax banks in any other way to speak of. They pay less taxes than any other industry.

Mr. Pierce. I agree with that, that is true.

The Chairman. Less than half.
Mr. Pierce. I agree. But you get a lot of resistance. For example, the obscure issue of repurchase agreements is a way of escaping reserve requirements. It is very much in the bank’s interest to find ways to avoid reserve requirements, because it enhances their profitability. As Professor Chandler pointed out, the regulators are always three steps behind in trying to keep up with these clever methods of avoiding required reserves.

If interest is paid on reserves, the incentive to come up with all of these clever methods disappears. I think interest should be paid. But this is a terrible year to do it. It is the last item that would be on my list of taxes to cut. And so I think one will have to wait.

Senator Sarbanes. Every year would be a terrible year. I don’t see why, as is indicated by Professor Chandler’s approach, if you are going to lose some revenue, it doesn’t make more sense to rationalize the reserve requirement by reducing the percentage required. It will still cost you revenue, but that is a better way to do it. If you can arrive at a reasonable figure to give you the base for monetary policy, why shouldn’t every bank in effect have to meet that condition to engage in the banking business?

Mr. Pierce. If the Congress wants to levy that kind of excise tax, to have a banking license, if it decides that is a proper public policy, fine.

The Chairman. If the Senator would yield at that point, we have always had that. It seems to me the burden of proof is on the side of those who say required interest on reserves. In the 200-year history of this country we have never had a situation in which the central bank has paid interest on reserves. Isn’t that right? And as Senator Sarbanes points out, we can’t find any, although other systems are different than ours, in which interest is paid by the central bank or ultimately by the taxpayer on reserves.

It seems to me a small price to pay for the advantage that bankers have. You go back to the old system of the goldsmith, and people deposited their gold bars, and you had 100 percent reserves, you would have to keep all of that gold there; then they developed fractional reserves, and it was a pretty good system. Now we want to in effect pay interest on everything. I think if we are going to move to that new system, there ought to be a clear, strong case for doing so.

Mr. Pierce. One of the cases is to charge for the services. The Fed has rationalized not charging for services as a compensation for not paying interest on reserves. Those services have been in existence as long as the Fed has been in existence. If the Fed starts charging for services, and does not pay interest on reserves, then the banks are worse off. You have increased the tax in effect. Maybe you want to do that.

Senator Sarbanes. It depends on what the reserve requirement is. You can change the amount of reserves that have to be held and thereby free up a significant portion of their assets to be earning assets and consider that a more rational way to straighten out the system, than to maintain higher levels of reserves and then pay interest on them.

If you are going to lose revenue, wouldn’t that be a more—would you put that ahead of paying the interest as the way to lose revenue?
Mr. Pierce. The lower the reserve requirement, the less injury to the banks, but also the greater the chance that you will injure monetary control. The purpose of the reserve requirement is to make relationships between monetary policy and money and credit more predictable and stable. The lower the reserve requirement is, the less predictable and less stable the relationship. And you don't get something for nothing in this. If the Fed reduces reserve requirements to 8 percent, money and credit would be less predictable than if reserve requirements were 20 percent.

So there is a tradeoff. The Treasury loses income in either case, because with less required reserves, there will be a loss in revenue that way, or if you lose the revenue by having reserve requirements at a level that is more appropriate for monetary policy, whatever the number is, and pay interest on it.

Senator Sarbanes. Do you think the current level is too high for monetary policy purposes? Significantly too high?

Mr. Pierce. The reserve requirement on large banks, about 16 percent, strikes me as too high.

Senator Sarbanes. Substantially too high?

Mr. Pierce. Yes. And it is also too complicated.

Senator Sarbanes. If that is the case, I don't think your previous reply really was on point. The question is still before you, if you are going to lose some Treasury revenue, is the more rational way to lose it as a first step by revising downward the reserve requirements, or by paying interest on reserves?

Mr. Pierce. I am not convinced that the Fed, in taking reserve requirements from 16 percent to 8 percent on demand deposits, did the appropriate thing. I doubt whether the Federal Reserve made the calculation to arrive at that 8 percent on the grounds of money policy. I think it made the calculation in order to try to keep members. The Fed tried to attract banks as much as it could by indirectly spending the Treasury's money rather than paying interest on reserves. I think that is unfortunate.

I think the issue ought to be faced as to what the appropriate reserve is for monetary policy.

Senator Sarbanes. That is a good point. If you pay interest on the required reserves, you introduce a factor into the level of the required reserve unrelated to monetary policy, that factor being that you are paying interest and you have a chance to save money on the payment by lowering the reserve requirement, so it seems to me it is a cleaner way to approach the system by saying what is the level we ought to have as a required reserve for purposes of monetary policy, and that is a condition of doing business, unencumbered.

If you pay interest, then you have pressure to get it lower to pay less interest.

Mr. Pierce. But you now have the pressure to have lower reserve requirements, in order to not cost the bank so much money. I don't think you avoid that pressure one way or the other. I think the pressure is less if you pay interest. At least from the private sector.

Senator Sarbanes. I am not arguing for the present system. I am trying to cut through it.
Mr. Pierce. I think the conflict is still there. The banks want low reserve requirements as long as they don’t receive interest. I don’t blame them. There is a conflict.

Mr. Chandler. Could I comment further on this?

First, the present system of reserve requirements are, I am sure, considerably above the level necessary for effective monetary management. A substantial cut would not cost much in terms of efficiency of management.

Second, the present discriminatory tax is really a disgraceful tax; it isn’t equitable by any standard. You leave out big banks that are nonmembers, who are not taxed at all. You tax smaller banks that are members, et cetera.

If you could move to a system of universal reserve requirements, suppose we could solve the problem of what is the right level, whether 8 or 9 percent or what, applicable to all transactions balances, then I think there is a good case for the Fed charging for its services it renders, then the question of interest on required reserves becomes much less important. Certainly not for membership reasons is it any longer important. It may be important from a political point of view, I am not a judge of that, in getting the reserve requirements, maybe this is a price, a political price that has to be paid to get the reserve requirements.

But it would still be true that even though the tax were in some sense equitable among all of the financial institutions, it is still a tax on financial intermediation. If the judgment is this tends to discourage the development and use of financial institutions, I think there is some argument for reducing the net tax by giving some interest on required reserves, in order not to have too large a burden upon the process of financial intermediation. And in the long run, of course, the tax is likely to be paid by stockholders, by depositors, by borrowers, and not say some corporation.

So it seems to me that the first thing to do is to get to the point where payment of interest on required reserves is less important. And then to make the decision on that.

Mr. Pierce. If I could raise a related point, I think that the evasion issue is very important. Banks have a strong incentive, and still would even with an 8 percent reserve requirement, to spinoff their deposit business to their holding company in order to avoid reserve requirements. It is perfectly possible for the finance company subsidiary of a bank holding company to issue liabilities that are not called deposits, they would be called something else, but they in effect would be deposits. These deposits would be outside of the banking system, would not have any required reserves and would not be insured. This behavior would be unfortunate, but the profit incentive is there. The company can have 8 percent reserve requirement by simply issuing the same savings account out of the finance company that it could issue out of the bank.

This shift would be socially undesirable. There is less regulation and no insurance for liabilities of holding company subs. I think there is no way to keep ahead of the banks in their avoiding regulations of this kind. They are very clever. And if you say all right, you can’t
issue paper out of the finance company, then they will dream up something else, some other way to do it. I think there is a social cost involved in bringing more and more banking outside of banking. You have a lot of that already, which reserve requirements certainly encourage. And so one buys something with paying interest on reserves, namely, you take away some of the incentive to spin activities off of banks.

The same phenomenon occurs with Eurodollars, there are all kinds of examples.

The Chairman. As a practical matter, we come down to the fact that the proposal by the Federal Reserve Board and by Chairman Reuss both, as I understand their proposals, would not provide for interest on reserves, would benefit the banks, their earnings would be increased, it would permit a lower level of reserves, a substantial exemption.

It would also permit a charge for services, also permit all depository institutions to have access to the Federal Reserve window, and I think it would be a very substantial improvement without having to get into this situation of food stamps for bankers.

Mr. Pierce. I agree. I have been trying to make the case why Congress should consider paying interest on reserves. I think if one gets all of the other features and doesn’t get the payment of interest on reserves, I would be delighted, provided the bill is in the form I suggest. I think it would be great.

The Chairman. Gentlemen. I want to thank you very much for a most interesting morning, it was so interesting we couldn’t let you go when we should have, because we have two very distinguished witnesses to follow you.

Our next witnesses are Leland S. Prussia, executive vice president, Bank of America, and Dr. James O’Leary, vice chairman of the U.S. Trust Co., representing the New York Clearing House Association.

I want to apologize, gentlemen, for having detained you. I am sure you enjoyed the testimony of the previous witnesses, too.

Mr. Prussia, you may proceed.

STATEMENT OF LELAND S. PRUSSIA, VICE CHAIRMAN AND CASHIER, BANK OF AMERICA

Mr. Prussia. Mr. Chairman and members of the committee, I am Leland S. Prussia, vice chairman and cashier of Bank of America. I am very pleased to testify today on S. 3304, the Federal Reserve Requirements Act of 1978. Because of the inequities in both the laws and regulations governing depository institutions, there exist significant disparities in competitive relationships among institutions. We believe that in addressing universal reserve requirements, interest on reserve balances, and charge for Federal Reserve services, S. 3304 would help to reduce these competitive inequities. Morever, this proposed legislation would improve the effective management of monetary policies. Bank of America, therefore, welcomes the opportunity to publicly support the thrust of these reform measures.
OVER THE YEARS, IMBALANCES AND DISTORTIONS DEVELOPED IN OUR FINANCIAL SYSTEM AS LEGISLATION WAS ENACTED IN A PIECEMEAL FASHION TO RESPOND TO COMPETITIVE INNOVATION. HISTORICALLY, SPECIAL TREATMENT SUCH AS HIGHER INTEREST RATE CEILINGS OR A TAX-EXEMPT STATUS WAS GRANTED SOME INSTITUTIONS SUCH AS SAVINGS AND LOAN ASSOCIATIONS AND CREDIT UNIONS WHICH PROVIDED THEM WITH SIGNIFICANT COMPETITIVE ADVANTAGES. HOWEVER, RECENT INNOVATIONS IN THE SCOPE OF PERMISSIBLE SERVICES SUCH AS NOW ACCOUNTS AND SHARE DRAFTS, AS WELL AS LEGISLATIVELY EXPANDED POWERS, SUCCEEDED IN CREATING A FURTHER COMPETITIVE imbalance favoring such institutions. S. 3304 PARTIALLY ADDRESSES THESE INEQUITIES.

BANK OF AMERICA PREFERENCES TO SEE CONGRESS ENACT COMPREHENSIVE FINANCIAL REFORM BASED UPON THE PRINCIPLE OF EQUAL TREATMENT—IN TERMS OF REGULATIONS, RESERVES, AND TAXATION—for institutions offering equal services. THE CONCEPT OF EQUAL TREATMENT FOR EQUAL POWERS PERMITS ALL FINANCIAL INSTITUTIONS TO COMPETE ON THE SAME BASIS WITH RESULTING ECONOMIC EFFICIENCIES AND BROAD PUBLIC BENEFITS.

IN THE AREA OF FEDERAL RESERVE MEMBERSHIP, THE INEQUITIES OF THE MEMBERSHIP BURDEN HAVE INCREASED SIGNIFICANTLY OVER TIME. MEMBER BANKS PAY AN IMPLIED TAX, ESTIMATED BY THE FEDERAL RESERVE AT $1.7 BILLION, IN THE FORM OF NONINTEREST EARNING CASH RESERVES MAINTAINED WITH FEDERAL RESERVE BANKS. WHILE MEMBER BANKS MUST HOLD IDLE BALANCES, NON-MEMBER DEPOSITORY INSTITUTIONS MAY USE THEIR RESERVES TO PURCHASE SERVICES FROM CORRESPONDENT BANKS OF THEIR CHOICE OR TO PURCHASE EARNING ASSETS.

BECAUSE NO COMPREHENSIVE REFORM APPEARS CURRENTLY POSSIBLE, AND BECAUSE OF THE INCREASING INEQUITIES OF THE MEMBERSHIP BURDEN, BANK OF AMERICA PROPOSES THE FOLLOWING PROGRAM, MAJOR PORTIONS OF WHICH ARE INCLUDED IN S. 3304.

1. CONCERNING RESERVE REQUIREMENTS, WE PROPOSE UNIVERSAL GRADUATED RESERVES, THAT WOULD:
   - BE APPLICABLE ON THE SAME BASIS TO ALL TYPES OF INSTITUTIONS OFFERING DEPOSITORY SERVICES.
   - BE LOWER FOR SMALLER SIZED INSTITUTIONS.
   - BE EQUAL FOR DEMAND DEPOSITS AND OTHER TRANSACTION ACCOUNTS.
   - BE EXTENDED TO INCLUDE TIME AND SAVINGS ACCOUNTS FOR ALL INSTITUTIONS WHERE SUCH ACCOUNTS ARE OFFERED.

2. CONCERNING PAYMENT OF INTEREST ON REQUIRED RESERVES, WE PROPOSE THAT:
   - INTEREST BE PAID AT A RATE THAT IS MARKET DETERMINED.
   - ONE RATE BE PAID TO ALL INSTITUTIONS REGARDLESS OF SIZE.
   - NO LIMIT BE SET ON THE MAXIMUM AGGREGATE INTEREST PAYMENTS.

3. CONCERNING CHARGES FOR FEDERAL RESERVE SERVICES, WE PROPOSE THAT SUCH CHARGES:
   - BE MADE EXPLICIT FOR EACH SERVICE.
   - BE PRICED ON THE BASIS OF DIRECT AND INDIRECT COSTS, INCLUDING TAXES AND AN IMPLICIT RETURN ON CAPITAL (TO BE COMPETITIVE WITH PRIVATELY OFFERED SERVICES).
   - PERMIT ACCESS FOR ALL INSTITUTIONS SUBJECT TO RESERVES.

I WOULD LIKE TO COMMENT IN MORE DETAIL ON EACH PART OF THE PROGRAM I HAVE JUST OUTLINED.
UNIVERSAL RESERVE REQUIREMENTS

Bank of America strongly supports the concept of universal reserves contained in S. 3304. As depository institutions become more alike, equality in regulations becomes essential. One category of financial institution, member commercial banks, should not be required to assume a disproportionate financial burden in order to secure for the general public such broad benefits as effective monetary policy management, an efficient payments mechanism, and the high quality of our financial system. Unequal reserve requirements, because they directly affect the profitability of financial institutions, may ultimately influence an institution's willingness to offer a service or innovate a new service—to the potential detriment of the general public.

We support the imposition of equal reserve requirements on all depository institutions—commercial banks, mutual savings banks, credit unions, and savings and loan associations—but we prefer a more expansive approach which imposes such requirements on any institution exercising depository powers. Institutions such as finance companies, securities brokers, and mutual funds accept deposit equivalents from their customers. A basic tenet of universal reserve requirements is competitive equality. These deposit equivalents are substitutes for reservable accounts offered by depository institutions and they should be subjected to reserve requirements. If this equal treatment principle were followed, the public interest would be better served by maximum competition among all participants wishing to offer financial services. In addition, the task of monetary policy would be made easier.

Although we prefer completely equal treatment for equal powers, there is some merit to the arguments for graduated required reserves based upon the total deposit size of an institution as implied in S. 3304 and the Federal Reserve's proposals. Many believe the burden of required reserves maintained at the Federal Reserve falls disproportionately on small institutions. Bank of America does not desire to stifle competition from smaller banks or other smaller financial institutions although smaller banks on average are more profitable than larger banks and, in many areas, do not offer the broad range of services generally provided by larger banks.

In the spirit of encouraging competition from smaller institutions, however, Bank of America supports a reduction in the lower levels of required reserves for transaction and time and savings accounts, as contained in S. 3304. Furthermore, with universal reserve requirements for all depository institutions, the reserve base upon which the Federal Reserve implements its monetary policies would be expanded considerably. The improved efficiency of policy implementation should permit significantly lower reserve requirements. We do not support the complete exemption of small institutions from reserve requirements as contemplated in S. 3304, which permits institutions with transaction accounts below 5 million to maintain no reserves, because all depositories should share to some degree in the burden of monetary management. We believe, however, that very low required reserves, coupled with interest payments on those reserves, provide sufficient compensation to remove any unnecessary burden on small institutions. Because the current city/country bank classification for determining reserve requirements is actually based on size rather than location, and because
our proposal embraces graduated reserves based on size, we see no reason to keep the current cumbersome city/country distinction. S. 3304 rightfully eliminates it.

We believe the very broad definition of a transaction account in S. 3304 is in the best interest of orderly financial regulation. By granting the authority to the Federal Reserve to define transaction accounts as new payment innovations occur, competitive equity is preserved by not permitting avoidance of defined regulation in this area. However, we believe a better approach to any definitional problem with transaction accounts or demand deposits is to eliminate any distinction between the two and to set reserve requirements for both these accounts at one low level. There appears to be no real basis for a distinction between demand deposits and transaction accounts, such as NOW accounts other than to circumvent regulations. Both serve the same functions and both represent immediately available funds. Demand deposit reserve requirements are currently very high, while transaction account requirements are low or nonexistent. Logically, reserves should be the same at one low level for all depository institutions.

Although not contemplated in S. 3304, reserve requirements on time and savings accounts should also be universally imposed on all financial institutions which maintain them. The expansion of powers at so-called thrift-type depository institutions, the loss of distinctions between thrift and transaction accounts, and the essential similarity of time and savings accounts at all types of institutions argue against any rational basis for excluding time and savings accounts from universal reserve requirements.

Implicit in our support of universal reserves is our belief that the Federal Reserve should have the power to set reserve requirements within legislated limits. The original Federal Reserve Act included reserve requirement levels as a tool of monetary policy; and if reserve requirements are truly universal, the use of this policy tool is enhanced. Nonbank depository institutions were ignored in the original act because they were small in size and number; however, today they represent the dominant share of the public's savings and should be brought within the orbit of monetary regulation. Additionally, the Federal Reserve is in the best position to evaluate the relative burden that required reserves place on different sized institutions. The Federal Reserve could, as conditions change, take appropriate action to maintain competitive equity.

The 4-year phase-in of reserve requirements for nonmember institutions is logical to prevent unnecessary problems or hardships. We also support the concept of nonmembers passing reserves through member banks or Federal home loan banks to the Federal Reserve. The uniformity of reserves for all institutions is more important than depositing directly with the Federal Reserve System. If an institution prefers not to deal directly with the Federal Reserve, there is no reason that it should. During the hearings concerning nationwide NOW accounts, Bank of America proposed that reserves on such accounts be held in the form of a special Treasury security, issued solely for that purpose, as a possible alternative to a passthrough reserve. We continue to believe that the use of special Treasury securities as a means of holding required reserves would provide a true market return on
such funds, promote competitive equity, and not hamper the implementation of monetary policy. We encourage the Federal Reserve to perform a feasibility study on the use of holdings of Treasury securities as a means of satisfying reserve requirements.

The Federal Reserve should clearly have the authority to require reports from nonmember depositories as proposed in S. 3304. The increased flow of accurate information would promote more effective and efficient implementation of monetary policy. The reporting requirement burden of member banks would be further equalized by extending these requirements to all institutions.

PAYMENT OF INTEREST ON REQUIRED RESERVES

Bank of America strongly endorses the proposed payment of interest on required reserve balances. S. 3304 ties the payment of interest to the idea of explicit charges for Federal Reserve services, a natural link which we previously mentioned. The payment of interest on required reserves would reduce the competitive inequities inherent in the current system.

As discussed above, one class of financial institutions—member commercial banks—is required to hold totally non-earning cash reserves, which other depositories hold their reserves in various earning forms (usually either correspondent balances or securities). A comparison of return on assets between member and nonmember banks, over time, shows that member banks had a consistently lower rate of return. The benefits of Federal Reserve services to member banks do not adequately compensate them for income lost in holding idle cash reserve balances.

Bank of America prefers that no limit be set on the maximum interest rate permitted on required reserves or on the aggregate amount that the Federal Reserve pays in interest on reserves; S. 3304 contains a limit of the sum of seven percent of net Federal Reserve bank earnings plus the revenues from charging for services. Either kind of restriction would only serve to limit the intent of paying interest on required reserves, that is, to reduce the burden of membership and to promote competitive equality among institutions. The rate that the Federal Reserve pays should be determined in the market, perhaps tied to the 3-month Treasury bill rate. In any event, we oppose a flat 2-percent maximum rate, as contained in S. 3304, because of the obvious inequity.

S. 3304 permits a higher rate of interest to be paid for the first $25 million of required reserves. However, because Bank of America favors graduated reserve requirements as a means of reducing the reserve burden of small institutions, we believe that payment of a differential rate of interest is neither necessary nor equitable. We urge that all reserves earn interest at the same rate.

CHARGES FOR FEDERAL RESERVE SERVICES

We are in favor of explicit pricing for Federal Reserve services. The current system tends to promote economic inefficiency. There is a very high price for access to Federal Reserve services—membership in the Federal Reserve System with its expensive reserve requirements—which disuades the majority of financial institutions from using these
services directly. However, once a bank chooses to meet the access price, that bank can use as much of the Federal Reserve services as it wants for no additional charge. This promotes inefficient use of resources because the marginal cost of providing a service is not equated to its marginal value to the user bank. Additionally, because the Federal Reserve does not charge for individual services, private sector innovation and competition is effectively stifled.

By explicitly charging for services rendered, the Federal Reserve also helps eliminate inequalities among banks of different sizes. The Federal Reserve's own analysis shows that small banks have a greater membership burden because they do not directly use Federal Reserve services or benefits, while large banks have a smaller burden because they use these services or benefits extensively. To the extent the Federal Reserve develops a competitive market pricing system, the charges imposed for the currently "free" Federal Reserve services nullify almost all the unequal burden based upon the size of a member bank. Graduated reserve requirements can be used to eliminate any remaining inequality.

We believe the general time frame for implementing pricing, as contained in S. 3304, is reasonable. The 1-year delay between publishing a fee schedule and pricing guidelines, and the implementation of actual pricing provides sufficient time to adequately comment on the proposals, as well as plan for the implementation of pricing. Also, the general list of services that are included in the pricing proposal under various plans—coin and currency, check collection, wire transfer, ACH, net settlement, security safekeeping, and new payment services—encourages competition by private sector firms in most cases.

Bank of America endorses a method of pricing which reflects not only the direct and indirect costs of the Federal Reserve, but which also includes an adjustment to reflect business income taxes and an imputed return on capital. The largest 15 bank holding companies in the United States, over the past 5 years, averaged a return on equity of 12 percent and paid taxes at the rate of 53 percent of before-tax income at a tax equivalent basis. These figures should serve as benchmarks for the Federal Reserve in developing its pricing proposal. This approach helps to insure that the Federal Reserve prices in the same competitive manner as a private firm. Explicit language in the legislation is an even better guarantee that the Federal Reserve does not unfairly underprice private sector competitors. The Federal Reserve's idea of "providing a basic level of payment services" implies that the public welfare requires the Federal Reserve to subsidize a given level of payment services. In the absence of any proof that the private sector will not provide payment services at reasonable costs to all institutions, the Federal Reserve should price on a purely competitive basis.

If truly universal reserve requirements are enacted for all institutions, Bank of America supports open access to all reservable Federal Reserve services for all institutions, including use of the discount window. Such universal reserves could be used for check (or transaction instrument) clearing accounts at the Federal Reserve. If all institutions are not subject to universal reserves, we do not support open access. Legislation that provides access for services based only on explicit Federal Reserve pricing or based on explicit pricing plus clearing accounts (S. 2595) does not provide for competitive equality. In
such an eventuality, member banks would still carry a disproportionate burden by virtue of their reserve requirements. There would remain the problem of unequal treatment for institutions having equal powers.

SUMMARY

Bank of America believes firmly in the principle of equal treatment for equal powers. To promote that principle, we strongly endorse universal graduated reserve requirements for all sizes of depository institutions offering financial services and all types of accounts held. Unequal burdens based upon the size of a financial institution should be eliminated by adopting graduated required reserves once universal reserves are accepted. Both the payment of interest on required reserves and pricing for Federal Reserve services are supported as a means of promoting competitive equity. Additionally, the pricing of services insures a more efficient allocation of economic resources. To do less than establish complete competitive equality among financial institutions is inconsistent with the whole concept of democratic government and the fundamental ethical foundation of our society.

Also I would like to comment that I was somewhat concerned by your observations, Senator Proxmire, about food stamps for bankers and things like that. I have always respected you as a very competent economist, but I don't think you followed the analysis all of the way through.

If you pay interest on required reserves, and also open up the system to greater competition, there is no reason why banks or any other financial institutions should have any windfall profits as a result of this system. As a consequence I think you would find enhanced competition and you would find banks passing those earnings on required reserves through to the customer, the general public. I think this would work in the best interests of all.

The CHAIRMAN. You could say that if you just abolished taxes, too. If nobody had to pay any taxes, you would have the same effect.

In view of the fact that bankers pay something like 17 percent of their income in taxes compared to 34 percent for other corporations, it is pretty hard to see why they should have a tax cut under the present circumstances.

Mr. PRUSSIA. If the tax cut is passed through, we have gone through——

The CHAIRMAN. If it is passed through, I would agree. I would like to abolish corporate income taxes. I have proposed that for the last couple of years. The New York Times, which is a liberal publication, also favors the abolition of corporate income taxes. But we don't have it, under present circumstances if you are going to have any kind of equity, it is hard to justify having a situation in which the banks have this advantage and now we are going to give them this kind of a tax reduction, particularly in view of the fact that you are getting an advantage, but even without that, if you accept the Federal Reserve's proposal.

Mr. PRUSSIA. Advantage in what form?

The CHAIRMAN. Your reserve requirements would be greatly lowered, so the burden of your reserve requirements would be lessened.

Mr. PRUSSIA. There is no reason why reserve requirements should be as high as they are.
The Chairman. That's right. They would be lowered under the Federal Reserve proposal, and under the House Banking Committee chairman's proposal. So you would benefit that way. You fellows want everything. I don't blame you for wanting it. I would if I were a top official of the biggest bank in the country.

Mr. Pruett. The point I am trying to make is that it doesn't mean our profits will be enhanced as a consequence of all of this. If you tie these two concepts together, a lightened reserve burden and encouraging competition (and we don't current have as much competition in the financial intermediary process as there should be), you will pass the benefits accrued to the banks through to the general public and everyone will benefit from it.

Mr. Chairman. As I say, I believe in reducing taxes very vigorously, as well as cutting Federal spending everywhere I can. It would just seem to me under present circumstances to reduce taxes further, when they are already as light as they are, the case is not quite that strong.

Mr. Pruett. Well, I have gone over my time.

The Chairman. Mr. O'Leary, it is good to have you back before the committee.

Mr. O'Leary. Senator Proxmire, it is a privilege and pleasure to be here. Let me say by way of introduction, I am accompanied here today by John Lee, who is executive vice president of New York Clearing House Association, and if there are questions that you have that may relate particularly to the operation of that institution, I am going to let him field them.

The Chairman. All right.

STATEMENT OF DR. JAMES O'LEARY, VICE CHAIRMAN, U.S. TRUST CO., REPRESENTING THE NEW YORK CLEARING HOUSE ASSOCIATION, ACCOMPANIED BY JOHN LEE, EXECUTIVE VICE PRESIDENT OF THE NEW YORK CLEARING HOUSE ASSOCIATION

Mr. O'Leary. My name is James O'Leary. I am vice chairman of the U.S. Trust Co. and I am appearing today as the spokesman for the New York Clearing House Association. I appreciate this opportunity to discuss S. 3304, a bill which comes close to resolving the persistent Federal Reserve System membership problem. I believe the legislation can be improved, however.

The first priority of any program directed toward solving the Federal Reserve's membership problem should be a reduction in the levels of reserves within the present statutory ranges. That can be done by regulatory action, and the Board of Governors should do so. Statutory ranges should also be reduced. Interest should be paid on the remaining reserves pegged to a market rate index and the Fed should fully price its services. We believe universal reserves for all depository financial institutions can only be acceptable if the total problem is addressed in that manner.

We believe that the Federal Reserve Board could discharge its responsibilities with significantly lower reserves than are now imposed on transaction balances and with no reserves on time deposits. Other nations have much lower reserve requirements. At an appropriate point in the economic cycle the Board should act to reduce reserves to the lowest possible level. Present reserve requirements constitute an undue
financial and competitive burden—much like a tax—upon member banks of the Federal Reserve System and upon their customers. This burden is not distributed equitably. That, clearly, is one of the reasons why banks are reluctant to apply for membership in the System and why many banks have chosen to leave the System.

We urge the Congress to reduce all of the statutory ranges. Section 103 should provide a lower range of 5 percent instead of 7 percent. But even more important, we urge action by the Federal Reserve to reduce the actual requirements imposed on member banks. This would be the simplest, most immediate and most direct means of reducing the membership burden. Differences in reserve requirements based upon institutional type or size are unjustifiable and should be removed.

When we were before you last October discussing the Fed’s role in the payment mechanism, we mentioned the incongruity of the existing Federal Reserve arrangement. Services are provided without cost to all depository financial institutions, but they are paid for by those banks which have joined the Federal Reserve System. Section 106 of S. 3304 would address that flaw by requiring the Fed to price its services.

After the burden of membership has been significantly reduced by a reduction in reserve requirements the means by which the Federal Reserve System provides services should be placed on a rational footing. Section 106 of this bill requires the Fed to proceed expeditiously toward that objective. Explicit charges should be imposed for each service offered by the Federal Reserve System and those charges should reflect all the System’s expenses, including the cost of capital funds employed and taxes. These pricing schedules could be designed to take effect after a reasonable transition period. But as and when effective, such explicit pricing schedules for Federal Reserve System services should be based upon principles of equity and fairness.

Without an “unbundled” pricing structure, private financial institutions cannot compete. The public sector should not offer its services in such a way as to prevent private institutions from demonstrating their ability to provide such services more cheaply.

Without the discipline imposed by explicit prices, many inefficient practices are encouraged or condoned. The growth of paper checks provides an example of an encouragement toward inefficiency. In the decade ending in 1977 the numbers of checks processed by the Federal Reserve rose at almost a 9½ percent annual rate. Against other measures of activity during the period for example, constant-dollar GNP or industrial production) this appears to be a relatively rapid growth rate. That impression is reinforced by the knowledge that the growth of check issuance undoubtedly would have been impeded had check issuers been subjected to the costs of Federal Reserve processing. Without pricing as an inducement to change payments methods, the benefits of new technology in the long-delayed less-check era will continue to be slow in coming.

The direct and indirect costs to the general public of funds transfer inefficiencies are undoubtedly sizable and certainly complex to estimate. The Federal Reserve itself has estimated certain costs of providing these services at around $250 million for 1977; the proportionate share of general administration and support would raise this figure to $300 million. Even this amount does not include private-sector equivalents of taxes and return on investment which need to be reflected in the
Federal Reserve's fee schedule. In any event, the total cost of providing these free services by the Federal Reserve in 1977 seems to have been at least $300 million; if priced on a basis equivalent to that of private sector firms, the figure could possibly be considerably higher.

In addition, the Federal Reserve System daily absorbs a reported $5 billion of float for checks not presented within the time period that funds have been credited to the depositing member. At an annual interest rate of 6 percent, this account for an additional $300 million in expenses.

This is only the beginning, but even this very rough calculation raises the question of whether the operating services furnished are really "worth" $300 million or so. The answer cannot be known because the services have not stood the marketplace test. That is, users have not been required to establish a cost/benefit calculus for existing Federal Reserve services in comparison with alternative modes of funds handling having alternative costs. An explicit pricing system would furnish evidence on the question of how much is being wasted by current practices.

Once total reserves have been reduced and a pricing schedule has been developed and implemented by the Federal Reserve System, banks holding reserves at the Federal Reserve should be paid interest on their reserves. This would be the only fair aid equitable procedure. The rate of interest paid on such reserves should be pegged to a market rate index. Under these conditions, the impact on Treasury revenues would be small if the tax effect of such payments is considered as well as the recovery of operating costs by pricing Federal Reserve services. Such modest compensation, in exchange for what have heretofore been sterile balances held on deposit with Federal Reserve banks, is far removed from the recently headlined "windfall" returns predicted for members banks.

Section 301 of the bill now before you provides for payment of interest on reserves. That payment should be calculated just as realistically as the cost of services is calculated—at the actual cost of money.

We favor the phase in provisions provided for present nonmember institutions by section 104. In our judgment they could even be extended to 4 years instead of 3 to make the transition less abrupt.

In conclusion, we commend the Congress for addressing the problems of Federal Reserve pricing and the role of Federal Reserve reserves. These issues are likely to become increasingly critical in influencing banks' ability to remain effective financial intermediaries in the years to come. It cannot be emphasized too much how critical it is to put the pieces together in the proper order. Reduction of reserve levels is by far the most important step; it should come first. Unbundling and pricing Fed services and the payment of interest on reserves logically follow. In all these measures equal treatment should be a central element. To impose higher burdens on some institutions rather than others is to discriminate against the customers of those institutions and thereby to encourage the development of less efficient alternative sources of financial services.

The CHAIRMAN. Dr. O'Leary, do you agree with Chairman Miller that the issue of membership with respect to monetary policy, membership in the Federal Reserve, is not as essential as it used to be regarded?

Mr. O'LEARY. The issue of membership is not as essential?
The Chairman. Is not as essential, given the possibilities of providing say universal reserves? Would you agree with the preceding expert witnesses, who indicated that the membership problem as far as monetary policy is concerned, would no longer be relevant if you had universal reserves.

Mr. O'Leary. Provided they were universal reserves. I would think the membership problem per se is not the heart of the matter. The heart of the matter is the fact that there are required reserves for member banks in the Federal Reserve System, and there are not equal reserves required for other financial institutions.

The Chairman. Would you also agree with Chairman Miller that that is an inequitable situation?

Mr. O'Leary. I think that is a very inequitable situation. Let me add one little additional piece of information which I think might have escaped some or at least two earlier witnesses, from the academic field.

One of the things that has come to my attention is that the whole question of deposits has spread into the life insurance companies. In effect today life insurance companies are selling contracts of a sort, which are really time deposits. It shows how competitive this whole process of deposits has spread through the whole system. I don't think that is recognized.

We have recognized the fact that technology and competitive pressures have brought in the NOW accounts and brought in share drafts—

The Chairman. Is that really new? Didn't you have insurance companies involved one way or another on the periphery in this already? Isn't that the answer? In spite of this, the banks have grown very rapidly, grown more than the economy as a whole has, and they seem to have done an excellent job.

Mr. O'Leary. I think what you are saying is, Haven't there always been policy loans, haven't there been funds left unsupplemented in contracts with insurance companies that have paid interest?

But there is a new development. And that is that in the last 15 years, the name of the game for a financial institution, including life insurance companies, is to be a full financial service type of an organization. This has affected the insurance companies as well—

The Chairman. Of course the insurance companies would turn around and say that two can play at that game as well as one. You are playing their game, too, you are horning in on their operations in their view. They may be wrong about that, not only with credit life, but in a number of other areas, you are becoming quite competitive with the insurance companies.

Mr. O'Leary. Don't misunderstand me, I am not casting a stone at the insurance companies. All I am saying is that when we recognize that there are transaction balances out there now in the hands of non-commercial banking institutions, we better not forget that possibly there are some transaction balances in the hands of life insurance companies, too. It has spread that broadly.

And it makes more difficult this whole question of being able to relate effectively to the money supply; it is complicated by the fact that not only a transaction balance has spread to other types of depository institutions, but they have spread even to types of institutions that we don't ordinarily think of as being depository in nature.
That is just a little additional complication. But I think it should be recognized and be recognized as part of the fact that as Mr. Prussia indicated, the financial system is extremely competitive and the competition is not only just between the banks themselves, but it is competition between a wide range of other types of financial institutions.

The Chairman. Mr. Prussia, as Chairman Miller pointed out, no other central bank has to worry about the membership problem. And it seems rather unfortunate that in this country the membership problem should color monetary policy at all. It shouldn't have anything to do with it. It tends to distort it to some extent.

For that reason, isn't the fundamental answer—I know you favor this among other things—but isn't the fundamental answer to this universal reserves?

Mr. Prussia. Absolutely. I think you have to go back and look at the history of how this whole system evolved, the point I was making in my testimony.

When the Federal Reserve Act was passed in 1913, the commercial banks were by far the dominant part of the financial intermediary system. I don't remember the exact number anymore, but I would say somewhere in the neighborhood of three-quarters of deposit balances were carried in those banks. Other types of financial institutions were virtually insignificant.

So it was logical to organize a system focusing on commercial banks, focusing on required reserves for commercial banks. That system made sense at that point in time. And partly because member commercial banks have been shouldering this burden of carrying reserves at a high level, other types of innovative financial systems have grown very rapidly. In spite of the fact that our growth has been reasonably good, we haven't grown as fast as other types of nonbank thrift institutions, because they don't shoulder the same kind of burden.

The Chairman. Whether we created it or not, we greatly enhanced the emphasis on housing and on trying to channel money through the savings institutions into housing. As you know the S. & L.'s have pretty stern restrictions on where they can invest their money. It is beginning to be modified and changed a little bit, but it is relatively limited. You don't really have substantial competition from the S. & L.'s, although they are very big in California. Your competition is with commercial banks, is it not?

Mr. Prussia. No, sir. It is the S. & L.'s as well. We have nearly $15 billion in consumer savings and time deposits on our books, we have nearly $6 billion in single family residential home loans on our books, and we have almost $6 billion in consumer credit on our books. We have an additional $1½ billion in real estate loans we have sold——

The Chairman. They could say, in spite of historical developments, they could say you are competing with them, too, because that is all they are allowed to do, and you are moving into their territory. Not that that is not good, that is good vigorous competition.

Mr. Prussia. Yes; this is the point. I think we ought to all be able to compete equally with one another.

The Chairman. I think that is right. When you have similar kinds of financial operations, then I think you ought to have similar rules. But I think the universal reserves ought to apply to transaction accounts, transaction accounts ought to also be perceived as being in some of these other institutions.
Mr. PRUSSIA. And savings deposits. There is no reason they ought not to be regulated in the same manner.

The CHAIRMAN. Mr. O'Leary, you said universal reserve requirements for all depository institutions is acceptable only if reserve requirements are reduced, and a market rate of interest is paid on reserves.

You are really asking for the moon. That would be a $1½ billion paid out to the banks on their reserves, plus a reduction in reserve requirements. So that as Mr. Prussia said, this wouldn't really help the banks, this would be passed on to the consumer. It would eventually, but there is a lag here, and you can live on your lag quite a while. This would enhance profits for a short period of time at least.

After all, in the first place, the benefits would be exactly equal, because the burdens are not equal now. The benefits would be to those who made the greatest sacrifices in the past, with the big banks, the big commercial banks benefiting by universal reserves being reduced and interest being paid on the reserves that remain. That would enhance the profits of both your institutions greatly, all of the clearinghouse banks in New York and the Bank of America in the short run.

You say in the long run—well, I guess John Maynard Keynes said “In the long run we are all dead.” But in the short run, you would live off the fat of the land.

Mr. PRUSSIA. No, sir, the competition would eliminate that very quickly.

The CHAIRMAN. I don't know about that.

Mr. O'LEARY. I welcome that sort of question you were asking me. May I comment on it, because I think there were a number of things said here today that need to be commented upon.

One is how profitable is the banking system. There seems to be a tone here that the banks are already quite profitable.

The CHAIRMAN. They are not profitable enough, I agree, they should be more profitable.

Mr. O'LEARY. I would venture before 2 years are out, you will be holding hearings on the adequacy of bank capital.

The CHAIRMAN. That's right, I was going to put it that way. We have already held hearings on that, we are very concerned about it. There is no question that bank capital is inadequate. I am not so sure that is the way to solve that problem, though.

Mr. O'LEARY. But when you talk about windfalls and asking for the moon, I think you have to ask that question, have the banks been able to build the capital base to carry out the necessary functions that they have in this country? I think with the economy growing in current dollar terms as fast as it is, I think one of the real questions that this committee is going to have to face is where is the capital going to come from to provide the banking system to have the expansion it will need to carry out that function effectively.

There are indications that there is an inadequacy of bank capital, at least some people view it that way, and there is some controversy over this.

The CHAIRMAN. This is shocking, there is no question about it, whether Arthur Burns is right or not in having a rule of thumb of capital being 8 percent of deposits. Bank of America has about 3 percent capital in relation to its deposits—
Mr. PRUSSIA. Over 3 1/2 percent capital to assets [Four and a half percent capital to deposits].

The CHAIRMAN. That still is grossly inadequate. The 10 biggest banks in the country have capital ratios of about 5 percent. So in general there is no question that capital is inadequate.

That doesn't mean we should follow a policy now that will enrich you overnight at the expense of the taxpayers.

Mr. O'LEARY. But let's go a little beyond in terms of some of the things that were said earlier.

The CHAIRMAN. Maybe you shouldn't grow quite as fast.

Mr. O'LEARY. One of the reasons why commercial banks have been paying relatively low taxes is because of heavy investment in tax-exempt bonds.

Now frankly my own feeling is that there may be some serious question about tax-exempt bonds, but the fact is that banks accept lower returns on those tax-exempt bonds as a trade-off for the fact that it reduces their taxation.

The CHAIRMAN. You are bringing tears to my eyes. Boy, lower returns; 6 percent return. I just bought some myself. You can get about 6.2 percent, perfectly safe, tax exempt. You put in a million dollars and get $60,000 back, and don't pay a dime of tax on it. A banker like yourself, you can put in $100 million and get $6 million back and pay nothing in taxes, zero.

Mr. O'LEARY. That is right, 6 percent versus 9 percent of prime loans and 9 percent on long-term corporate bonds. So there is a sacrifice in yield that is being taken there to take advantage of the tax exemption.

The same thing is true, some of that lower tax base is based on leverage leases, taking advantages of the investment tax credit. Well, Congress has created the investment tax credit, and if it has an investment tax credit, the way I look at it---

The CHAIRMAN. I am not so sure that is such a big bonanza for the banks. Every other corporation can take advantage of it, and does.

Mr. O'LEARY. Then I would go another step, and that is to say that I don't think there is adequate realization of the extent to which the reserve requirements enter into the cost to customers out there.

Mr. Prussia made this point, it was made in the earlier discussion. But for example, it has been, it is becoming less common, for corporations to pay for loans under less than full pricing, let's say, in terms of the interest rate, with compensating balances.

Any bank in calculating the value of that compensating balance, deducts out of there the increased reserves that will come from that compensating balance.

The CHAIRMAN. I couldn't agree with you more. Part of what we are trying to propose here is that we explicitly price these services, and that we provide not only interest—that was my next question which I might address to Mr. Prussia. Why not, on interest on reserves, wait for a bill we hope to enact promptly to permit interest to be paid on demand deposits. Then you have interest paid on correspondent balances, explicit pricing of the services provided, and you have a far more competitive system, dynamic system, and more efficient system. Because you would have the premium paid on who can do the job for the lowest cost.

Mr. PRUSSIA. We certainly wouldn't argue with that. We think broad-scale reform would be the better way to go.
The Chairman. The fundamental question is why shouldn't interest on reserves await the enactment of, or the repeal of, the prohibition of interest on demand deposits?

Mr. Prussia. That is logical. We just think this is a case for equity. If you could do all the reforms at once, it would produce a much better system—better competition, more equitable, all of those things. But if reform has to be done in stages, I would agree this would be the way to go about it.

The Chairman. You see, it is a quid pro quo. If we pay interest on reserves, the banks want that, but interest on demand deposits, some banks—your bank might perhaps recognize and perhaps Mr. O'Leary's bank—but many many of the smaller banks in my State and I suspect around the country are opposed to that. They consider that to be something that would cost them money, reduce their income, and be very difficult for them.

So that we have to put that package together, it seems to me, if we are going to have a logical comprehensive change that makes the whole system more competitive.

Mr. Prussia. Right. I think universal reserve requirements are most important. No. 2, reduction in reserve requirements would be important. No. 3, would be eliminating some of the inequities which are not covered in this legislation, like the quarter percent differential in regulation Q. This would be the type of thing that would enhance competition, and improve the system all around, as well as permit the Federal Reserve to do a better job of monetary management. The other things, if they can't be done all at once, we would say they have a lower priority.

The Chairman. Mr. O'Leary, you said the Federal Reserve's float is about $5 million daily, and a 6-percent interest, and $300 million additional expenses are both by the Federal Reserve. Who benefits from that $300 million expenditure by the Federal Reserve?

Mr. O'Leary. What it does is through the banking system as a whole, that float increases the availability of funds for the system.

The Chairman. So the banking system as a whole benefits from that $300 million?

Mr. O'Leary. Yes, sir. Incidentally let me say I agree generally, personally, and I think probably the clearing house banks would agree with the idea that if there were payment of interest on reserves, that it would be appropriate to have payment of interest on demand deposits also. On all transactions balances. So that I don't think we have any great quarrel with that.

The Chairman. Is your proposal that the Federal Reserve charge for float indirectly by counting it as a cost rather than directly charging the banks that now benefit directly from the float?

Mr. O'Leary. I would think that logically, this being one of the services provided by the Fed, that that would be subject to some specific service charge.

We think of it as a service being provided, having a cost; logically then there ought to be some service charge for it.

The Chairman. To get back to the broad necessity of competition. Mr. Prussia, you said in your statement that institutions such as finance companies, securities brokers, mutual funds, accept deposit
equivalents from their customers. You argue they should be subject to reserve requirements.

I might agree with that. Does the deposit-taking characteristics of these firms impair the Federal Reserve's ability to implement monetary policy, in your view?

Mr. Prussia. To the extent that they represent an increasing proportion of the total system, yes.

The Chairman. Is it at a stage now where you think it has a significant effect?

Mr. Prussia. There are all manners of degree. But I think in a universal reserve requirement system, your criteria ought to include all deposit-like instruments and not confine yourself to those offered by the four principal types of financial intermediaries.

The Chairman. I think that might be practical provided you had a sufficient level of exemptions, so that you wouldn't have to try to administer everybody.

Mr. Prussia. Yes, sir.

The Chairman. If you had a $25 million or a $50 million exemption, that might be practical.

Well, gentlemen, I want to thank you for your testimony very much. It has been a very interesting morning for me.

Mr. Prussia. May I make one more comment, Senator? I can't leave it on the record your statement that Bank of America is undercapitalized. I think I could debate that with you, and I would like to have the opportunity to do that with you sometime.

The Chairman. Opportunity to do what?

Mr. Prussia. Debate the capitalization question.

The Chairman. You think you have ample capital?

Mr. Prussia. We are a well-run institution, we have a good record and I think we can stand on our capital.

The Chairman. In that case, you don't need any of these benefits here. We are concluding this testimony by saying interest on reserves shouldn't be necessary to enhance the capital of banks.

Mr. Prussia. I think we should have universal reserve requirements, obviously. That doesn't affect the capital issue.

The Chairman. All right. The committee will stand adjourned.

[Thereupon, at 12:10 p.m. the hearings were adjourned.]

[Additional material received for the record follows in the appendix.]
APPENDIX

August 23, 1978

Senator William Proxmire
Room 5241
Dirksen Senate Office Building
Washington, D.C. 20510

Dear Senator Proxmire:

RE: S. 3304 - The Federal Reserve Requirements Act of 1978

The Conference of State Bank Supervisors is pleased to comment on the above proposal which would establish and mandate universal reserve requirements for all transaction accounts which aggregate in excess of $5 million at every depository institution; require the Federal Reserve to impose charges for certain services offered by the Federal Reserve banks; and authorize the payment of interest on reserves held in Federal Reserve banks.

While the views of the Conference at this time will be directed principally to the issue of the Federal Reserve Board having reserve-setting authority over all depository institutions with $5 million or more in transaction accounts, the Conference would like the opportunity, if it should desire to do so, to comment at a later date on other aspects of this bill such as the paying of interest on reserves held at the Fed, or the charging by the Fed for services which it performs for banks.

Compulsory Universal Reserves With the Federal Reserve System

The Conference is of the position that the Federal Reserve System has made no showing that in order to effectively carry out its monetary policy responsibilities it needs the proposed universal reserve-setting powers over all commercial banks and other depository institutions. In testifying before the House Committee on Banking, Finance and Urban Affairs on August 4, 1978 on a proposal (H.R.12706) which, like S. 3304, is designed to deal with the Fed’s membership problem, CSBS pointed out that it has not been demonstrated that the decline in Fed membership was a causal
factor in faulty monetary policies during much of the period from 1965 to 1975. The contrary view, in fact, is widely held by a number of monetary observers from outside the Federal Reserve System, and by some from within the System. Declining Federal Reserve membership, if it is a problem, is primarily of a practical political-constituency nature.

The Fed has long sought universal reserve-setting power over depository institutions on the grounds that it is essential for its monetary policy role. There have been a number of studies on this issue. Many of the studies have reflected views contrary to those of the Fed. Several such studies were listed by then Chairman George LeMaistre of the FDIC in his testimony before the House Banking, Currency and Urban Affairs Committee on August 4, 1978, relative to H.R. 12706 and related proposals.

CSBS, in 1974, commissioned a study which was conducted by Professors Ross M. Robertson and Almarin Phillips. The study entitled, Optional Affiliation With The Federal Reserve System For Reserve Purposes Is Consistent With Effective Monetary Policies, concluded that:

Major monetary policy weaknesses have been revealed in the recent past, and a prudent person should anticipate more in the future. Optional affiliation of some banks with the Federal Reserve for reserve purposes, however, cannot be considered high on the list of factors contributing to these weaknesses, if eligible at all for inclusion.

The proposal for compulsory universal affiliation for reserve purposes is without redeeming merit from a national interest standpoint, and Congress very wisely has consistently rejected such proposals in the past.

Levels of Member Bank Reserves

S. 3304 would establish ranges of required reserves for all transaction accounts, and for time and savings deposits. Numerous proposals as to levels of reserves have been made to Congressional Committees in recent weeks. The Conference has not opposed lowering reserves for member banks. CSBS, in fact, has consistently expressed the view that such action of lowering reserves for member banks be taken by the Fed.

The so-called reserve/membership problem, largely or entirely could have been solved by the Fed unilaterally, or with
readily acceptable statutory changes long ago; and the Fed could still do so with relatively moderate reductions in member bank reserves. The amounts of reduction needed are not subject to statistical precision. Data developed by CSBS, plus observations of the marketplace, however, suggests that reserve reductions averaging one to two percentage points on total deposits of banks not heavily involved in correspondent banking would be adequate to halt most withdrawals caused by high reserves. The Federal Reserve Board should be urged to pursue such readily available solutions to its so-called membership problem and withdraw from efforts to gain more and more power over more and more financial institutions with power an apparent end in itself.

Such action can be taken without the wide-sweeping proposals incorporated in S. 3304 and without adversely impacting on the Fed's ability to discharge its monetary policy responsibilities.

This statement will not address itself to the question of which liabilities should have lesser or greater reduction in reserves, nor to the question of levels of reserves for member banks which likely will not consider withdrawal; e.g., banks heavily involved in correspondent banking. The Conference respectfully requests the opportunity to comment on these issues should it appear appropriate to do so at a later date.

Positive Aspects of Withdrawal Pattern

The Fed withdrawal pattern has positive qualities. Withdrawals to date from the Fed have strengthened the ability of the private correspondent banking system to serve the thousands of communities of our Nation. As banks have withdrawn reserves from the Fed, nearly all such banks have allocated part of their new-found liquidity to help pay for more private correspondent services. By contrast, Fed proposals for compulsory universal reserves would economically force transfers of funds from the private correspondent banking system into the Fed System. This would have the adverse tendency to socialize our Nation's inter-bank system and would also do so concealed by indirection rather than by a revealed proposal.

Additionally, the withdrawal pattern has built-in limitations. There is a floor below which membership will not fall. That floor is established by the fact that a large proportion of the remaining member bank assets are now in banks that enjoy net benefits from membership. Membership in the System usually is one requisite to a dynamic correspondent banking operation by individual banks. There is a strong relationship between Fed membership and correspondent banking services.
Those banks that are heavily involved in the correspondent banking business tend to retain membership in the System. Only a few which have withdrawn from the Fed are heavily engaged in correspondent banking. Thus, even if membership close to the present level is significant from monetary policy or public interest standpoints, and the Fed has not demonstrated this to be the case, there is a floor which will assure that a majority of commercial bank deposits remain in Fed constituent banks.

**Fed Access to Data**

The Conference believes that the Federal Reserve Board should have ready access to statistical or other data from nonmember banks or other depository institutions, which subject is addressed in Sec. 103 of S. 3304. However, the Conference believes there should be a demonstrated need by the Fed for data which is essential to carrying out its monetary policy responsibilities. While CSBS and others, notably the FDIC, have cooperated with the Fed when a need has been shown to exist for such data, the Conference believes that each request for data from a bank should stand the test of cost-benefit analysis. The Fed should not have the unrestrained right to any and all data it might request, or in the form it might request same. Experience suggests that such authority could likely violate cost-benefit principles.

**Summary Comments**

In summary, CSBS believes that compulsory universal reserve requirements should not be vested in the Fed or in the Congress. Available evidence does not support this action as necessary for the Fed to carry out its monetary policy role. Optional affiliation with the Fed is consistent with sound monetary policies and should be retained. In addition, there is a serious question as to long-term effects of universal reserve requirements on the dual banking system. If all banks were forced to establish their reserve policy in accordance with the dictates of the Fed, many banks ultimately might convert to national charters, if for no other reason than to get rid of one regulator--the State Bank Supervisor. Should this occur, the state banking segment of the dual banking system could become virtually meaningless, a development which we cannot believe the Congress would support or encourage.

CSBS believes that the reserve-setting concept suggested in this communication by the Conference would more than correct any inequities that might now exist between groups of member
and nonmember banks, would halt withdrawal from the Fed, and would permit effective monetary policy. At the same time, with states retaining the authority to determine reserves for state-chartered nonmember banks as at present, this would avoid the possibility of damaging the decentralized banking structure.

Sincerely,

Lawrence E. Kreider
Executive Vice President-
Economist

/1sg
Statement of August 21, 1978

Submitted to the
Committee on Banking, Housing and Urban Affairs
United States Senate

by

Milton Friedman
Paul Snowden Russell Distinguished Service Professor
of Economics
University of Chicago
and
Senior Research Fellow
Hoover Institution
(Stanford University)

This statement follows the order of the questions listed in the letter from Senator William Proxmire to Dr. Milton Friedman of July 28, 1978.

A. Federal Reserve Membership

I do not believe that a decline in Federal Reserve membership threatens the conduct of monetary policy or control of the monetary aggregates. Neither does the erosion of the membership threaten the safety and soundness of the banking system.

I have long believed that it would contribute greatly to the conduct of monetary policy to separate completely the two aspects that are combined in the present Federal Reserve System: first, control over monetary aggregates or of monetary policy in general; second, relations with a particular set of commercial banks regarded as members and subject to regulation by the Reserve. The combination of these two functions in a single institution has impeded the efficient performance of either the one or the other function.

For control of monetary aggregates the crucial requirement is simply that the Federal Reserve have a monopoly over the issuance of high-powered money. Given that it does so, the control of broader monetary aggregates simply rests on a systematic relation between them and high-powered money. That relation is just as close for nonmember banks as for member banks. It does not depend on required reserves but is maintained equally by the prudential reserves that banks feel it desirable to keep.
B. Reserve Requirements

1. The most important desideratum with respect to reserve requirements is that if there be required reserves they be the same for transactions accounts, savings accounts, and time deposits so that shifts among such deposit categories do not release or absorb reserves.

As to the numerical size of the required ratio, two alternatives make logical sense. One is zero required reserves. Simply allow banks to hold whatever prudential reserves they think appropriate. The second is 100 percent required reserves against transactions accounts with interest paid on such reserves and with complete freedom for banks to pay interest on such accounts, and then to require zero reserves against all other forms of accounts.

2. It follows from what I have just said that one logical alternative is to have mandatory reserve requirements for no financial institutions; another, at the other logical extreme, would be to have them mandatory for all transactions accounts at 100 percent. If some other reserve requirements are imposed, it is preferable that they be the same for all institutions offering the same kind of deposits. That would reduce the disturbances produced by deposit shifts.

3. The Federal Reserve needs no flexibility to adjust reserve requirements in order to conduct monetary policy. On the contrary, changes in reserve requirements are a clumsy and inappropriate tool for conducting monetary policy and have done more harm than good.

C. Payment of Interest on Reserves Held at the Federal Reserve Bank

1. I have long recommended that interest be paid on reserves at the Federal Reserve Bank at a rate of interest roughly equal to the market interest rate on short-term money.

2. I do not believe the Federal Reserve should be given discretion in the rate of interest to be paid on reserves.

3. The proposal here is simply a question of form; it does not matter in the slightest whether reserves are held in the form of special Treasury securities or in the form of open-book accounts as now, provided the interest rates paid on the two are the same.

4. At present the zero interest rate on reserves is a special tax on member banks and their depositors. The question is whether this is a desirable
tax. If it is, it should be imposed by Congress deliberately as a matter of policy, not be an accidental byproduct of the accidental development of monetary arrangements.

One essential point that must be emphasized is that payment of interest on reserves must be accompanied by elimination of the present prohibition of the payment of interest on demand deposits. It would be desirable to eliminate also all limits on interest rates that banks may pay on time and savings deposits. In that way, interest paid on reserves would be passed through to depositors.

D. Pricing of Federal Reserve Services

1. I believe the Federal Reserve should be required to price its services at a market rate, including imputed return on capital and taxes. I see no reason why this is an appropriate activity to be subsidized by the taxpayer.

2. If the Federal Reserve prices its services at a market rate it is competing with all other institutions that can provide such services, and there is no reason why all depository institutions should not be able to get such services from the Federal Reserve if they so desire.

3. This point raises many complex issues. Personally I am in favor of abolishing the Federal Reserve's discount facility. That would eliminate such discount arrangements for both member banks and all other banks. If it is not abolished, I see no reason why all banks should not have it available to them.

I cannot close without emphasizing the crucial importance under present circumstances of eliminating the prohibition of interest on demand deposits and the limits on interest under Regulation Q. If the prohibition of interest on demand deposits had never existed or if it had been repealed long ago, there never would have developed the proliferation of ingenious techniques for getting around the prohibition. There would have been no NOW accounts, no POW accounts, no COW accounts; telephonic transfers would probably not have reared their head. The financial structure would have developed as a much more rational and efficient mechanism.
August 24, 1978

Senator William Proxmire
Chairman
Committee on Banking, Housing
and Urban Affairs
5300 Dirksen Senate Office Building
Washington, D.C.

Re: S.3304, the Federal Reserve Requirements Act of 1978

Dear Senator Proxmire:

Interbank Card Association is a not for profit membership corporation composed of over 10,000 financial institutions which participate in bank card programs, most notably the Master Charge card program. Interbank soon expects to implement a debit card program under the trade name of "SIGNET". In support of both its Master Charge card and SIGNET card programs Interbank has established highly sophisticated electronic transmission systems by which Interbank members interchange transaction information necessary to effectuate the bank card transactions.

We have with great interest reviewed the provisions of S.3304, the Federal Reserve Requirements Act of 1978 and wish to provide you with our comments specifically as to Section 106, pricing of services.

Interbank fully agrees with the philosophy of imposing charges for Federal Reserve services, assuming the FRB should undertake an operative role in providing electronic services. However, in Interbank's opinion the imposition of charges raises the critical but yet unanswered issue of whether services otherwise provided by the private sector should be offered by government at prices which the private sector likely cannot meet. This is especially of concern to us as it may relate to the operations by the Federal Reserve of (retail) electronic fund transfer services.

Interbank's position on this issue has been in the past clear and unswerving: there is no historical, policy or business justification for the Federal Reserve to offer free of charge services which can be/are furnished by private entities or, if priced, computed on a non-cost related basis.
Given what is now a reality of the Fed's development of interregional ACHs we welcome an approach which requires pricing of Federal Reserve services. However, we urge that Congress speak further to the question. Our review of the letter published in the Congressional Record of July 14 to you from Chairman Miller raises for us fundamental and ponderous questions which we believe Congress must now address in legislation in order to appropriately and explicitly direct the Fed in the development of its pricing propositions.

As the legislative section 106 is presently composed, Congress has delegated wholly to the FRB the responsibility for determining the content and breadth of its pricing doctrines. S.1304 is devoid of any Congressional statement as to the desired values which the Board should integrate into its scheme. Inasmuch as the pricing of Federal Reserve services undoubtedly will impact directly on financial institutions as well as the public at large, Congress should deliberate and offer a composite of factors to be weighed and objectives to be attained in the endeavor. Interbank suggests that Congress cannot be silent but rather needs to give an expressive recitation of the elements to be considered in developing a pricing rationale to guide the Board in this pioneering and critical assignment.

Specifically, in the creation of a pricing schedule Interbank suggests that Congress declare that the Board's pricing of services should be computed on a fully allocated cost basis including all, and not merely a select few, services provided by the Federal Reserve, priced individually. That is, Federal Reserve charges should be imposed on the total costs associated with furnishing each service. For example, start-up costs for development and maintenance should be computed and figured into the service charges. This would work to stave off inadvertent non-competitive pricing activities on the part of the Federal Reserve and assure that charges are real-market based.

Left unchanneled by Congress, the Board may not price its services as suggested here but rather, might price services at cost or below cost level. In fact, Chairman Miller states as much by declaring to price services based on "mature volume levels". One can only conjecture now, and in a vacuum, as to what a mature volume level will be ultimately. To us, this statement is mere gloss for the Board's predilection to price its services at a less than cost basis. Such an approach to pricing would unquestionably create a disincentive for the private sector to offer services provided by the FRB.
In concluding its intensive study into the role of government in electronic transfer of funds, the National Commission on Electronic Funds Transfer called for the assessment of charges for Federal Reserve services "on an equitable and fully allocated cost basis". The Commission explained the consequences (using as an example, ACH services) if such an approach was ignored:

"If the Federal Reserve does not separately offer and price its ACH services on an equitable and fully allocated cost basis, potential private sector competitors will be discouraged from entering the market."

Chapter 14 pg. 216.

Accordingly, Interbank strongly urges Congress to legislatively direct the Federal Reserve to price its services on a fully allocated cost basis.

In the event Congress does not adopt a requirement of full cost-allocation pricing, we urge your further consideration of how prices will be scheduled particularly as they may be applied to any EFT operation by the Federal Reserve. There are factors considered in the Board’s pricing thesis which our members find objectionable and without any compelling business or public policy justification. For example, we are puzzled and concerned as to the meaning of Chairman Miller’s statement that charges will be assessed "by geographic area, activity, and class of work processed..." Without additional explanation to the reader, it appears that high activity (large volume users) may be accorded a favorable price differential. In our opinion, such would have an unreasonably disproportionate impact on the smaller financial institutions which depend on Fed services.

We also query here how the geographical distinctions will be implemented (by Bank, Branch, or office area?) Also, may Fed offices generate their own pricing systems sua sponte, as it were? More specifically, Chairman Miller concedes that it may be necessary for "some offices" to revise their prices "to maintain competitiveness". But, with whom and how will this competitiveness be manifested and met? If the Federal Reserve has the ability to undercut its prices in a given market area only to be subsidized by its higher set charges in a non-competitive area then it would be guilty of subsidization-for-monopoly-sake. We submit this is not the direction Congress would have the Board follow.

As an organization anxious to compete with other payment delivery services we are naturally resistant to what we perceive to be a potentially government subsidized pricing scheme. The opportunity for the described scenario is clear, as would be the results. Without Congressional instruction otherwise the Federal Reserve would have the market posture and artificial where-with-all to discourage other entrants from the service providers market.
In order to avoid the stagnation of a non-competitive environment any pricing policy adopted by the Federal Reserve should reflect Congressional advice and further, we urge, should include the fully allocated costs of providing each separate service. By setting forth these minimal standards Congress will be encouraging the development of competitive private sector clearing and settlement systems, a quintessential product of U.S. policy in this burgeoning era of electronic banking technology. The innovative spirit characteristic of and demonstrated by the existing private sector systems is well suited to spur the development of payment systems capable of meeting the demands of the exacting user population and of providing an ever-improving quality of service for the public.

Very truly yours,

Amy Topiel
Associate Counsel
The Honorable William Proxmire
Chairman
Committee on Banking, Housing, and Urban Affairs
United States Senate
Washington, D.C. 20510

Dear Mr. Chairman:

This letter is in response to your invitation of July 26 to submit the views of the savings bank industry on S. 3304. Our comments will be addressed to the three issues which you set forth in announcing hearings on this legislative proposal: 1. to provide for maintenance of reserves for certain deposits held by depository institutions; 2. to require the imposition of charges for certain services provided by Federal Reserve Banks; and 3. to authorize the payment of interest on reserves held at Federal Reserve banks.

In offering these comments, it is appropriate to point out that no savings bank is a member of the Federal Reserve System. Therefore, our industry does not have direct experience with some of the issues involved in these legislative proposals. On those matters where such experience may be crucial, our comments will necessarily be general, rather than detailed.

1. Reserve requirements on transactions accounts for nonmember depository institutions. It is the long-standing position of the savings bank industry that, with regard to reserve requirements on checking, NOW or other types of transactions accounts, state-chartered savings banks which are not members of the Federal Reserve System should be treated in the same way as state-chartered nonmember commercial banks. Further, we believe that required reserves on transactions accounts for state-chartered nonmember institutions should be set, and held, as determined by the appropriate state authorities.
We believe that this position is consistent with effective Federal Reserve monetary policy. It is difficult to imagine any industry more sensitive than savings banks to Federal Reserve policy, as witness the recurrence of disintermediation and resultant cutbacks in mortgage lending activity at our institutions during periods of monetary restraint. Imposition of reserve requirements on transactions accounts are clearly unnecessary to make savings banks responsive to counter-cyclical monetary policy and would merely add to current pressures on their earnings positions, which are already mounting as a result of recent changes in Regulation Q deposit interest rate ceilings.

2. Payment of interest on reserves held in any Federal Reserve bank. Although no savings banks are members of the Federal Reserve system, we have no objections to the payment of interest on reserves of member banks.

3. Providing for pricing principles and a schedule of fees for Federal Reserve System services. We support the concept of providing for fees, uniform for all depository institutions, for automated clearing house, transfer, settlement or other services offered by the Federal Reserve. The principle of uniform fees is especially important as thrift institutions gain third party payment powers and as electronic funds transfer systems are developed and implemented. The availability of such services should in no way be contingent upon membership in the Federal Reserve System. Access to the discount window is a major advantage for System members. If the costs of Federal Reserve membership are deemed to be excessive, appropriate adjustments can be made through payment of interest on reserves, as proposed by various legislative proposals before the Committee.

I hope that these comments will be helpful.

Sincerely yours,

Saul B. Klaman
President
INTRODUCTORY COMMENTS

My name is Bernhard Romberg and I am President of the Payment and Administrative Communications Corporation and its operating subsidiary, the Payment and Telecommunication Services Corporation. These corporations, also known as the BankWire, provide wire transfer funds payment services to the banking industry. I appreciate this opportunity to present the BankWires views to the House Banking Committee on the need for equitable pricing of operational services provided by the Federal Reserve in the payment systems area.

First, I will describe the organization and activities of the BankWire as a private sector provider of electronic funds transfer services. I will then discuss the effect of Federal Reserve activities in this area, commenting particularly on pricing and access. My
Comments here will focus on that segment of the payments mechanism related to wire transfers. I will then discuss our views on the legislative proposals being considered by this Committee, limiting my comments on those aspects related to the charging of services provided by the Federal Reserve.

**The BankWire**

The BankWire is a private corporation organized as a business cooperative to provide banks with low cost and efficient funds transfer services for inter-bank payments. It operates a substantial computer-based switching system which, on an average day, handles 18,000 communications involving over 20 billion dollars in payments, thus playing an important role in the nation’s payments mechanism. The BankWire's operations are financed completely through charges to its users, which are based on a standard fee of 60¢ per message.

As a business cooperative, the BankWire is owned and managed by its member banks. All banks using BankWire services are members of the cooperative and have a voice in the management of the organization. Its 185 member banks are located in 36 states. Over 90% belong to the Federal Reserve and there are members in every Federal Reserve District. The deposit assets of this membership are in excess of 500 billion dollars, or more than 60 percent of the nation's commercial bank deposits. Membership is open to any financial institution providing depository banking services.
The members elect annually a Board of Directors, who are also senior officers of member banks, in such a way that there is at least one director from each Federal Reserve District, thereby assuring nationwide representation. The BankWire's form of organization has been approved by both the Federal Reserve Board and the Comptroller of the Currency, and its cooperative status has been approved by the Internal Revenue Service. We wish to emphasize that the BankWire is industry owned, industry financed, and industry managed, with membership open to all financial depository institutions.

The BankWire of today and its predecessor organizations have been providing wire transfer services since 1952. BankWire I, an automated system, served the banking industry well from 1968 until May of this year. In May, BankWire II, a major new computer-communications system went operational and replaced the previous system. The specifications for BankWire II were developed by representatives from banks--large and small--from all over the country. The system features new types of transactions and facilities for better management of funds transfer activities. It will also have a significant capability for batch transmission, which can be used for inter-ACH (Automated Clearing House) requirements as well as direct batch communications between members. High reliability and efficiency have been achieved through the use of the latest in computer and communications technology. BankWire II represents a major commitment--over 10 million dollars--by the private sector to provide for banking's current and future needs in inter-bank payments.
The Federal Reserve operates a substantial funds transfer system, generally known as the Fedwire. A major--and rapidly growing--use of this system is for third party wire transfers between commercial banks. Typically, these are transfers--or payments--made from one bank to another where the payment is to be credited to the account of a customer of the receiving bank, the so called "third party". Preliminary results of BankWire surveys show that such third party transfers represent the predominant use--between 60 percent and 80 percent--of the Fedwire by commercial banks. These are transactions made by banks on behalf of their customers and need not involve the Federal Reserve directly. The Federal Reserve is thus providing services which are comparable to those which have been provided for some time through the BankWire. Furthermore, the Federal Reserve is actively pursuing a program to expand the use of the Fedwire for third party transfers--thereby enlarging its role in an area already served by the private sector.

As for charges, the Fedwire is basically free to the banks that use it. There is a charge for the terminal equipment located on a bank's premises, and a nominal charge for those few third party transfers which are for amounts less than $1,000.
but for all practical purposes there is no charge for the overwhelming bulk of usage.

This situation can be compared with the BankWire, which must recover all of its costs through a charge of 60¢ per message. As shown in Figure 1, these costs include all communications lines, the computer hardware, systems development, all salaries, general administration and overhead, working capital, as well as Federal, state, and local taxes. With the Fedwire, users are not charged for any of these normal business expenses.

**IMPACT OF THE FEDWIRE**

The activities of the Federal Reserve in wire transfer services have had a profound impact on the BankWire. Since 1974, membership in the BankWire has declined from 230 to 185 today, or a decrease of 20 percent. Of even greater impact has been the decline in average daily message traffic from 26,000 per day to the current levels of 16,000, equivalent to a 31 percent drop. At the same time, in talks given at various conferences, the Federal Reserve has reported that usage of the Fedwire is approximately 70,000 per day, and growing at a rate of 15 to 20 percent per year.

Surveys of present BankWire users, as well as in-depth interviews with members who have left the system, clearly indicate the two most
## Figure 1

### Comparison of Bankwire and Fedwire Charges

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<th>COMPONENT</th>
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<th>FEDWIRE</th>
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<td>1. Terminals</td>
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<td>2. Communications lines</td>
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<td>3. Computer hardware</td>
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<td>4. Operations</td>
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<tr>
<td>a. Personnel</td>
<td>INCLUDED IN STANDARD CHARGE</td>
<td>NO CHARGE TO USERS</td>
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<td>b. Site</td>
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<tr>
<td>5. Development/replacement</td>
<td>CHARGE OF 60¢ PER MESSAGE</td>
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<td>6. Marketing/user liaison</td>
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<td>7. Administration</td>
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<td>8. Working capital</td>
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<td>9. Taxes</td>
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Important reasons for the declining use of the BankWire. The first of these is costs; the second of these—which I will discuss shortly—is settlement. The Fedwire is free, while the BankWire costs 60¢ per message. With the continued pressure on operating costs, there is a natural and understandable inclination on the part of operating personnel to take whatever steps they can to reduce costs, and this in turn leads to the significant diversion of traffic from the BankWire to the Fedwire. Declines in traffic have been a major factor in forcing the BankWire to increase its unit message charge, which in turn leads to further traffic declines.

If the Fedwire were to charge properly allocated costs, including development expenses, equipment, and factors for the cost of capital, we have good reason to expect BankWire charges would be more than competitive with the Fedwire. Under such circumstances, and if the BankWire was able to provide settlement, we are confident that the BankWire would carry a major fraction of the third party wire transfers, which would assure its long term viability.
ACCESS FOR SAME DAY NET SETTLEMENT

The second significant factor in the decreasing use of the BankWire is a difference in the settlement mechanism for funds transferred through the Fedwire as compared to those through the BankWire. Because of its unique role as a central bank, the Federal Reserve can settle transfers from one bank to another by debiting the reserve account of the sending bank and crediting the reserve account of the receiving bank. This provides "immediate availability" of the funds transferred. To be competitive from a product/service standpoint, the BankWire needs access to this settlement mechanism.

The BankWire membership has designed a highly efficient means of accomplishing settlement, known as "net settlement". With net settlement, the BankWire would accumulate totals for the funds transfers sent and received by each bank and then report this to the Federal Reserve as a single net debit or credit balance for each bank. These balances would be posted by the Federal Reserve to the member bank's reserve account on that same day. With this facility, the transfers through the BankWire would provide "same day availability" with many fewer settlement entries flowing through the
central bank system. This would also simplify and facilitate present reconciliation procedures as well as reducing peak volume bottlenecks in the Fedwire. Implementation of this service requires that the BankWire have access to the Fed's settlement system in such a way as to permit the BankWire to be competitive with the Fedwire. Without this same day net settlement capability, the future viability of the BankWire as a private sector alternative is in doubt.

It should be noted that this net settlement approach continues the role of the Federal Reserve System in the final settlement process of the payments mechanism without requiring each individual payment transactions to be processed over a system operated and subsidized by the Federal Reserve. This approach is in accord with the recommendations of the National Commission on Electronic Funds Transfers in that it enhances the development of the private sector clearing arrangements without expanding the role of the Federal government in the payments mechanism.

In December, 1977, the Federal Reserve announced its intention to provide the BankWire access for net settlement. Since March, we have been working with Federal Reserve System personnel to define more precisely the operational, technical, and legal aspects related to such settlement. It should be em-

The Bank net settlement approach is in accord with recommendations of the National Commission on EFT.
phased that, for the BankWire to be able to provide wire transfer and related payments services which are realistically competitive with those which are provided by the Federal Reserve, it is essential that there be a reasonable degree of functional parity between BankWire funds transfer services and those available through the Fedwire. This can be accomplished by having the Federal Reserve apply the same acceptance criteria to a BankWire net settlement statement as to any other Fedwire transaction and promptly acknowledge the finality of such balances or notify the BankWire that some balance is not acceptable. Anything less than this would prevent the BankWire from providing competitive capabilities.

With the introduction of realistic charges for all services and by giving other providers of payment services equitable access to facilities which are currently unique to the Federal Reserve (because of its central bank role), the BankWire and other organizations will be able to compete in providing efficient and innovative payment services to meet the nationwide range of consumer and corporate needs.
COMMENTS ON PROPOSED LEGISLATION

It is our fundamental conviction that any legislation affecting the operations of the Federal Reserve should require the Federal Reserve to charge explicit prices for payments related services. In particular, such charges should apply to the wire transfer of funds, check collection, Automated Clearing House services, net settlement services, and any services related to the electronic transfer of funds.

To assure a legitimate competitive environment, where the private sector would find it economically feasible to provide services and create initiatives, it is essential that the Federal Reserve, in its pricing for services, take into full account all direct and indirect costs incurred in providing such services, including overhead, an allocation of imputed costs that would take into account taxes that would have been paid, and the return on capital that would have been provided had the payment services been furnished by an organization in the private sector—as well as all directly identifiable costs for operations, development, marketing and user support services. To do otherwise would encourage the less efficient check payments system rather than an electronic one.

In its pricing, the Federal Reserve certainly should be given every opportunity to be as competitive as possible. However, it should not be permitted to use its resources or unique position as a central bank to provide...
services at artificially low costs, even if this is done only with the declared intention of being competitive. If the private sector is able to introduce services of a particular class at low costs or is prepared to risk its capital with the hope of a long term profit, this does not mean that the Federal Reserve or any governmental agency should be allowed to charge less than its fully allocated costs (including various imputed allowances), in effect using price cutting and its predominant position, to suppress competitive initiatives.

Finally, there should be no tie-in between the charging of services and payment of interest on reserves. For instance, any restriction applicable to a particular bank which would limit the interest it receives on reserve balances to the cost of services it purchases, or some absolute or percentage relationship tied in any way to the purchase of services would, in the private sector, be construed as an illegal "tie-in sale". For there to be a truly competitive environment, which would permit private sector initiatives, it is essential that the activities of the Federal Reserve as a provider of payments services be separated completely from its other activities as a regulator of the banking industry, manager
of the nation's money supply, and fiscal agent of the Federal government. Thus, the charging and operating practices of the Federal Reserve should be such that the private sector can also compete in providing payments services to the Treasury and other departments of the Federal government.

With respect to the charging for payments services provided by the Federal Reserve, we believe that the bill introduced by Congressman Stanton (H.R.12706) represents sound and constructive legislation, and encourage its favorable consideration. We do suggest that it could be improved by further wording which would restrict the Federal Reserve from engaging in any pricing or other competitive practices which would be prohibited in the private sector. We would also encourage more rapid implementation of the pricing of such services, calling for these to be announced by July 1, 1979 and implemented by January 1, 1980, instead of July 1, 1980 as suggested in H.R. 12706.

We are absolutely convinced that requiring the Federal Reserve to charge fully allocated costs for its payment services will bring about major innovations and expansions in such services which will be of far reaching benefit to the public—both individual consumers and corporations. There have been tremendous strides in computer, communications, and other technologies which are directly
applicable to new and efficient payments services which can meet a large variety of individual needs. It is, however, essential that the artificial depressant of free payment services provided by the Federal Reserve be eliminated. Once users have to pay the requisite cost for services, then there will be a realistic economic environment in which others can compete with the expectation of a reasonable return. Different services will be introduced as a result of competitive innovation to meet the differing needs of the marketplace. New businesses will be formed and private sector employment will grow. Our economy is too complex—too dynamic—to be served adequately by a single approach to payments—just as one type of automobile does not meet the needs of all consumers, nor does one style of clothing meet everyone’s desires.

The Federal Reserve proposal H.R. 13477 is not adequate in that it does not provide for the pricing of Federal Reserve services. In the Federal Reserve’s July 10 press release, the Board also suggests that it might not price any services if its program for universal reserve requirements were enacted. This would continue a government subsidy of the payments mechanism while stifling private sector initiatives.

In summary, we truly believe that, by calling for the Federal Reserve to charge fully allocated explicit prices for its payments services, the Congress will be enacting
legislation which will be of long term and far reaching benefit to the entire economy. This will come about because such competitive pricing will provide an environment in which the private sector can compete in providing higher quality and lower cost services to the public and the government. It will lead to new economic activity in the private sector, which will also increase employment as well as having the salutary effect of increasing Treasury revenues from additional taxes paid by the private sector. To prevent such charges from being punitive, the Federal Reserve should alleviate the present burden of re-reserves imposed on its membership. However, any such relief should be completely separate from, and in no way conditioned upon, the purchase of Federal Reserve payments services.
UNIVERSAL RESERVE REQUIREMENTS, INTEREST ON RESERVES, AND CHARGES FOR SERVICES:
A COMPARISON OF 12 CENTRAL BANKS WITH THE FEDERAL RESERVE SYSTEM

Evan Migdail
and
Steven M. Roberts*

*Evan Migdail was an Intern with the Committee on Banking, Housing and Urban Affairs, U. S. Senate, during the Summer of 1978 when this paper was prepared. Steven M. Roberts is Chief Economist for the Committee.
This study has been prepared in anticipation of consideration by the Congress of legislation amending the Federal Reserve Act.\textsuperscript{1} Its purpose is to compare the Federal Reserve System and proposed changes in the system with the structure of Central Banks of twelve industrialized countries. The proposed changes would create universal reserve requirements for all depository institutions, initiate payment of interest on reserves, and mandate charges by the Federal Reserve for certain banking services. These services are currency and coin services, check collection, net settlement, wire transfer, automated clearinghouse, securities safekeeping and any new payment services that the Federal Reserve should choose to provide at some future time.

It should be noted from the outset that consideration of banking operations abroad has long been a starting point for planning for changes in our own banking law. In fact, the hearings and studies pursuant to consideration, in 1913, of the original Federal Reserve Act included extensive discussion of the operations of foreign central banks.\textsuperscript{2} It is hoped that consideration now of the operations of foreign central banks will aid in evaluating the merits of the proposals recently made by the Federal Reserve to the Congress.

I. THE AMERICAN DUAL BANKING SYSTEM

Foreign Central Banks and the Federal Reserve System are readily

\begin{itemize}
\item[(1)] 12 U.S.C. § 221, et seq.
\item[(2)] Hearings Before the Committee on Banking and Currency, United States Senate, 63d Cong. 1st Sess., 1913 (in three volumes).
\end{itemize}
comparable as to their technical structures. In fact, much symmetry is found in the areas considered in this study. However, as an aid in comparison, it is necessary to call attention to one area that is unique to the United States, that being the American dual-banking system.

In the United States we have both a federally controlled system of banking and a state-controlled system. On the other hand, the foreign states considered, generally have a system of banking that is totally under control of the central government.

This difference stems from the structure of federal-state relations in American Constitutional Law. The federal Congress is not given any explicit authority over banking in the Constitution. However, the Congress is given explicit authority over such matters as the regulation of interstate commerce, collection of revenues, the raising and supporting of the military, and the power to coin money and regulate the value of money.

At the same time, the Constitution grants authority to the Congress to do what is "necessary and proper" to carry out its explicit powers. From this "elastic clause" the Congress has implied certain other powers. In the context of banking, it has long been the law that the Congress has the power to incorporate national

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(3) U.S. Cons. Art.1, § 8.
(4) U.S. Cons. Art.1, § 8, cl.18.
banks and regulate them. Through the interstate commerce power, Congress has had the power to insure banks and extend credits and loans.

Therefore, the Federal Reserve System as it was instituted was based on "membership." Membership is obligatory for all national banks, but voluntary for state-chartered banks. Currently reserve requirements and regulations set by the Federal Reserve apply to member banks only. These member banks represent 40 percent of all commercial banks and 72 percent of total bank deposits.

This difference, going directly to the proposed legislation, merely serves to compel the need to study foreign systems, and does not detract from the merit of such studies. However, it must be kept in mind in evaluating the more extensive control over banking by other central governments.

II. THE PROPOSED LEGISLATION

Proposed legislation would require all depository institutions, defined as those covered by the Federal Deposit Insurance Act, the Federal Credit Union Act, and the Federal Home Loan Bank Act, and the National Housing Act, to maintain reserve requirements against their transaction accounts in amounts determined by the Federal Reserve. This change has been requested and justified by the Federal Reserve Board on the theory that although state non-member banks are required to keep reserves by state law, in many cases those banks are able to hold those reserves in interest bearing forms. Therefore, according to the Federal Reserve Board, a degree of inequality had occurred, causing competitive inequities between federal and state banks. By its proposal the Federal Reserve Board has said that this competitive inequality would be reduced, and therefore, that the withdrawal of state banks from the system would stop. In the past eight years, 430 member banks have left the system and only 103 nonmember banks have joined.  

A second proposal made by the Federal Reserve Board is the payment of interest on reserves left on deposit at Federal Reserve Banks. Such payments are not made at this time and, in fact, have never been made in the history of the Federal Reserve System. In fact, there is serious question as to the existing authority under the Federal

Reserve Act for such payments to be made without explicit authorization by the Congress.

Finally, there is a proposal that would mandate that the Federal Reserve charge for the previously enumerated banking services. At present, the Federal Reserve Board has legal authority to do so, but does not exercise this power. That is, services are provided to members without charge in recognition of the reserves they hold at the Federal Reserve Banks.

Four of the foreign central banks studied in this paper charge directly for banking services and in the eight other systems reviewed banking services are provided in part by the central bank, and also by private institutions. Six central banks provide services without charge, and in all instances where private institutions provide some banking services, there is a charge for the services.

Throughout this paper the terms 'clearing' and 'settlement' are used. Clearing refers to the accounting process when funds are drawn at one bank against accounts in another. Settlement refers to the process involving the actual transfer of funds.

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III. FOREIGN CENTRAL BANK STRUCTURES

The attached chart shows in detail information about the relationship between the central bank and the commercial banks within its jurisdiction. It enumerates the reserve requirement relationship, whether interest is paid by the central bank on reserves held with it, whether the central bank provides bank services, and on what basis.

The following material is intended as an expansion of the information in the enclosed chart. It is compiled primarily from information provided by the International Monetary Fund, Embassies of countries studied, the FINE Study, conducted by the House Banking Committee Staff, the British and Canadian Bankers' Association, and materials listed in the bibliography. Most of the information is current to 1977.

(a) Great Britain

The Bank of England, the central bank of England and Wales, is responsible for note issue, administration of the national debt, and acts as government agent in certain important financial transactions and adviser to the government on financial matters.\[11\] It is also the primary body responsible for monetary policy, which it influences through setting of the rediscount rate, open market transactions, and reserves that must be kept by all British banks with the Bank of England.

\[\text{(11) See generally British Information Services, British Banking and Other Financial Institutions (1974).}\]
<table>
<thead>
<tr>
<th>COUNTRY</th>
<th>RESERVE REQUIREMENTS</th>
<th>INTEREST OR NO INTEREST</th>
<th>MANDATORY ALL BANKS</th>
<th>SERVICES PROVIDED</th>
<th>SERVICE CHARGES</th>
</tr>
</thead>
<tbody>
<tr>
<td>AUSTRIA</td>
<td>9% on demand deposits; 7% on time, if less than 12 months; 6% on time if more than 12 months.</td>
<td>None is Paid</td>
<td>Yes</td>
<td>Provides currency, but check clearing &amp; other interbank services are provided by private banks.</td>
<td>None for currency services -- private banks charge for their services.</td>
</tr>
<tr>
<td>BELGIUM</td>
<td>TWO TYPES -- LEGAL &amp; MONE-TARY:</td>
<td>None -- unless reserves are held in the form of govt. bonds, in which case the market rate is paid.</td>
<td>Yes - No Differences on the basis of size of location of banks.</td>
<td>Coin &amp; Currency; National Bank provides a forum for large commercial banks to settle obligations; Check clearing, transmission, &amp; other interbank services are provided by private, profit institutions.</td>
<td>No Charge; National Bank charges fee for settlement services; Private institutions charge for their banking services.</td>
</tr>
<tr>
<td>CANADA</td>
<td>Current Accounts 12%; Time Deposits 4%; Savings 4%.</td>
<td>None is Paid</td>
<td>No - Chartered banks only. This excludes trust banks &amp; loan banks.</td>
<td>Only service by central bank is delivery of note issue. Check clearing by Canadian Bankers Assoc. Other services are privately provided.</td>
<td>No Charge; Charge; Charge</td>
</tr>
<tr>
<td>Country</td>
<td>Reserve Requirements</td>
<td>Interest or No Interest</td>
<td>Mandatory All Banks</td>
<td>Services Provided</td>
<td>Service Charges</td>
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<tr>
<td>West Germany</td>
<td>Up to 30% for demand deposits; 20% for time deposits; 10% for savings; at all credit inst's,</td>
<td>No-Central bank holds reserves as interest free current accounts.</td>
<td>Varies according to size, location (i.e., proximity to a regional central bank), &amp; importance of bank. Used basically for monetary policy.</td>
<td>Check clearing &amp; settlement for large banks only; coin &amp; currency services.</td>
<td>None</td>
</tr>
<tr>
<td>Switzerland</td>
<td>Reserve fund of 1/20 of a bank's net profits yearly Deposits for inflation control</td>
<td>None is Paid</td>
<td>Yes</td>
<td>The Bank issues bank notes, ships currency, safekeeping of securities, check clearing.</td>
<td>No Charge</td>
</tr>
<tr>
<td>Great Britain</td>
<td>12½% day to day liquid reserves consists of cash &amp; securities. Minimum balance on cash deposit. 1½% special cash reserve Monetary cash reserve can be called in at any time</td>
<td>None is Paid</td>
<td>Yes</td>
<td>Provides currency in England &amp; Wales. Check clearing, wire transmission, and settlement services are provided by private inst's.</td>
<td>No charge for shipping currency; Services by private institutions are provided at a charge.</td>
</tr>
<tr>
<td>COUNTRY</td>
<td>RESERVE REQUIREMENTS</td>
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<tr>
<td>ITALY</td>
<td>Legal reserve fund of 1/20th of net annual profits until such fund reaches 1/5 of the entire capital.</td>
<td>Yes—current rate is 5.5%</td>
<td>Yes—for all commercial &amp; savings banks.</td>
<td>Check clearing; Currency &amp; coin services; Wire transfer services; Settlement services.</td>
<td>No Charge</td>
</tr>
<tr>
<td>Bank of Italy</td>
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<tr>
<td>FRANCE</td>
<td>Can be set up to 15%—vary according to nature, amount &amp; variation of the elements of liabilities to which they apply.</td>
<td>No</td>
<td>Yes</td>
<td>The Bank provides check clearing, currency &amp; settlement services</td>
<td>No Charge for any services.</td>
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<tr>
<td>Bank of France</td>
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<tr>
<td>MEXICO</td>
<td>Currently set at 3%; two types, legal &amp; monetary.</td>
<td>Only a portion of this (over 50%) receives interest.</td>
<td>Yes</td>
<td>Check clearing, coin &amp; currency, wire transmission &amp; settlement services.</td>
<td>Bank of Mexico charges for all services.</td>
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<tr>
<td>Bank of Mexico</td>
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<tr>
<td>DENMARK</td>
<td>No reserves as such but: Liquidity ratios; Deposits taken at times for monetary policy or check clearing</td>
<td>Not Applicable</td>
<td>Yes</td>
<td>Check clearing &amp; transmission services; also wire transmission.</td>
<td>No Charge for services. Only when there is check clearing, a charge is registered in the commercial bank's balances with the central bank.</td>
</tr>
<tr>
<td>Danmarks National Bank</td>
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<tr>
<td>COUNTRY</td>
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<tr>
<td>GREECE</td>
<td>20% private sight &amp; restricted; 5% of private savings; 2nd reserves of 20% private sight &amp; restricted, 3% savings.</td>
<td>None on first reserves</td>
<td>Yes for all commercial banks. No exceptions.</td>
<td>Central bank provides currency settlement services, &amp; check clearing.</td>
<td>Central bank charges for settlement &amp; check clearing based on a % of the volume transacted.</td>
</tr>
<tr>
<td>Bank of Greece</td>
<td></td>
<td>2nd reserves with interest at market rate. Currently at 9.5%.</td>
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<tr>
<td>JAPAN</td>
<td>Varies by type of institution &amp; size between 1.625% &amp; 0.125% for time, &amp; 2.5% to 0.25% for other deposits. Banks are classified by size &amp; function, ie, agricultural v. savings, etc.</td>
<td>No interest paid on any reserves.</td>
<td>Yes-No exceptions for any banks.</td>
<td>Check clearing &amp; settlement done through a current account kept with Bank of Japan by commercial banks; also providing of yen, wire transmissions, &amp; discounting of bills.</td>
<td>No direct charges for services, however, adjustments are made in the balances of commercial banks with Bank of Japan.</td>
</tr>
</tbody>
</table>
Implementation of central bank policy in England has been effected traditionally through informal agreements rather than by statute. However, should there be a "breakdown of trust," the Bank of England Act of 1946 gives the Bank authority to implement the above banking policies. At this writing, the Bank of England has not yet had occasion to use its statutory authority.

British banks are broken down into four classifications. These are deposit, merchant, British overseas and commonwealth and the foreign and consortium banks. Crucial to the Bank of England's supervision of the economy is the provision that all British banks provide it with statistics regarding their assets and liabilities (including reserves), a requirement that has led to their being called 'statistical banks.'

Since 1971 there has been a mandatory 12.5 percent reserve requirement, on day-to-day eligible liabilities, for purposes of controlling money and credit. There may also be minimum deposits with the Bank of England for facilitation of clearing (clearing balances) as well as a 1.5 percent special liquidity cash reserve. In addition, at any time the Bank of England may call in a further monetary reserve. Of the various types of reserves that may be required, interest is payable only on this monetary reserve, and would be calculated at the market rate of interest. Reserves are required generally for the purpose of monetary control, however, reserves are also held so as to ensure that British banks are able to meet their day-to-day demands of the clearing system.
The Bank of England provides note and coin issue to England and Wales at no charge for shipping. Check clearing is done by private institutions, known as the clearing banks. By way of a cooperative network, the heads of each bank send an accounting of checks drawn against the other banks for clearance. Non-clearing bank members can participate in clearing through a special agent appointed for clearing purposes. While clearing is done by the private institutions, the clearing banks themselves may maintain a clearing balance with the Bank of England and clear checks by way of bank drafts drawn against these balances. Settlement services are also provided by private institutions. For these services there is a charge, as the private clearing and settlement institutions are profit making.

It is probably valid to say that the authority of the Bank of England would appear to be more narrowly drawn than that of the Federal Reserve, but that the small number of banks and the power of moral suasion gives the Bank of England greater overall day-to-day control of the banking system. Also, unlike the United States, the Bank of England covers all banks, there being no dual banking system.
(b) **Belgium**

Banking in Belgium is controlled by two organizations, the Royal Banking Commission and the Bank of Belgium. The former is responsible mostly for micro-economic policy, such as supervision and regulation of individual banking institutions. The Bank of Belgium performs services generally associated with central banks such as providing coin and paper currency, providing settlement facilities, holding bank reserves and serving as the lender of last resort. It is also in charge of monetary policy. Under the Belgian political structure, which is different from the American federal-state model, banking is controlled in large part by Royal decree and is applicable to all banks.

Reserves are deposited in the Bank of Belgium as a fixed proportion of the monetary liabilities of all banks. Generally there is no interest payable on reserves. However, a portion of the reserves may be held in the form of government bonds, and interest, on these bonds, is payable at the market rate.

The Bank of Belgium provides coin and paper currency at no cost. Check clearing is provided by private institutions, and these charge for their services. Settlement may be effected through facilities of the Bank of Belgium, which basically consist of facilities where officials of the few banks can meet to clear accounts. The Bank of Belgium charges a low fee for the use of the facility. This is easily accomplished owing to the small number of banks in the country and the consequent ease of coordination.
The Deutsche Bundesbank, the post-war West German central bank is structured in a way similar to that of the Federal Reserve System. There is one central bank with branches in each of the eleven states of the German Federation. The President of each of the regional banks, along with the Board of Governors of the main central bank are responsible for monetary policy. The Bundesbank has control over all banks in the Federal Republic.

There is also a Bank Supervisory Authority which oversees bank regulatory policy in coordination with the Deutsche Bundesbank. The latter can refuse to offer its rediscounting facilities to banks if they should violate recommendations of the Supervisory Authority. The Bundesbank collects statistical information from all West German banks for the purposes of planning policy.

The basic justification for reserve requirements held by the Deutsche Bundesbank is the effectuation of monetary policy. Germany in the post-war period has been among few countries to use variable reserve requirements to implement its monetary policies, basically as a check on the balance of payments and as a means of reinforcing the official discount rate.\(^\text{12}\/\)

Reserves are held as interest-free deposits with the central bank. There are upper limits on the amount of the reserve, and these can be varied according to size of the banks, location, and importance.

As far as location is concerned, proximity to a regional central bank would be a factor in keeping a smaller reserve.

Settlement services are offered only to "large" banks, and the central bank also performs check clearing and provides coin and paper currency. There is no charge for these services.

(d) France

The French banking system is under the supervision of two organizations, the Bank of France and the Banking Commission. The Banking Commission is presided over by the Governor of the Bank of France. It is responsible for banking and reserve ratio policy at the micro-level, whereas the Bank of France is primarily concerned with overall economic policy.

The Bank of France is similar in function to the other central banks reviewed. It is the issuer of currency, performs clearing and settlement services, is responsible for foreign banking and monetary control, and performs miscellaneous functions on the Treasury's behalf.

In similar fashion as the Deutsche Bundesbank, the Bank of France has experimented with variable reserve requirements. The variations go to the amount and nature of the liabilities to which they apply. Under French law these can be set at up to 15 percent. The French requirements apply to all banks without exception. The Bank does not charge for its banking services, and no interest is paid on reserves.
(e) Italy

The Bank of Italy is not owned in any part by the government. Instead it is owned by shareholders, who elect all the directors, except for the Governor, who is chosen by the directors with the approval of the government.\(^{(13)}\) The shareholders are commercial and savings banks. The Bank of Italy is one of the few foreign central banks with a permanent office in the United States for the study of American financial institutions.\(^{(14)}\)

The Bank of Italy has broad authority in the areas of credit control and monetary policy. It also performs typical central banking functions such as providing currency, check clearing and settlement, and wire transfer services. Charges are made for the wire transfer services, and a percentage commission is taken on settlements. There are private clearing houses in Italy, as is the case in Great Britain, and the Central Bank has the power to advance, for a period of up to ten days, funds to facilitate settlements between the banks and the clearing houses.

Reserves are mandatory for all commercial and savings banks, and are deposited with the Bank of Italy. These are calculated as a percentage of deposits with a ceiling on the total accumulation. Interest is paid on the reserves, the current rate as of July 1978 being 5.5 percent.

\(^{(13)}\) Id. at 307-310.

\(^{(14)}\) Bank of Italy office is in New York City.
At times a percentage of the reserves may also be held in government bonds or securities, as is the practice in Belgium. The breakdown of such an arrangement is to be determined by the Bank of Italy and must allow at least 15 percent of the requirement to be held with the Bank of Italy. Under these circumstances, those revenues on deposit with the Bank of Italy would receive 5.5 percent and the rest would obtain whatever yield the bonds or securities offer.

(f) Denmark

The Danish banking system is far less complex than that of most other countries in this study, a surprising fact because of the comparatively large number of banks for so small a nation. While there are three large Copenhagen banks, with over 50 percent of the total banking business, there are also 78 independent banks.¹⁵

Banking in Denmark is under the supervision and control of the Danmarks Nationalbank. The key mechanism used by the bank for the control of monetary policy is the discount rate. There are no reserves comparable to those required by the other central banks. However, the central bank does have certain requirements designed for the protection of the banking public. The first of such requirements are liquidity ratios, consisting of holdings in the vaults of each bank. These are cash or easily marketable securities. The aggregate amounts must not be less than

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(15) This should be compared to Canada, below, with only twelve institutions that are legally designated as banks.
15 percent of a bank's commitments payable on demand or at less than one month's notice.

Besides the liquidity ratios there are deposits taken by the central bank for the purposes of check clearing (clearing balances). The size of such balances are determined by the central bank. There is also authority for the central bank to require additional deposits with it for monetary purposes. In either of these two cases, any deposits left with the central bank would receive the market rate of interest.

Banking services such as providing currency, check clearing, and wire transmission of funds are provided without charge.

(g) Switzerland

The Swiss National Bank, which predates the Federal Reserve by six years, is the only note issuing bank in Switzerland. It is not owned by the Confederation but is a public limited company with its shares quoted on the stock exchange. About 42 percent of the issued capital (50 percent of the total capital) is in private hands, the rest being owned by the cantons, the cantonal banks or other public entities. At one time, as is presently the case in Great Britain, the Swiss Bank operated on the basis of mostly informal agreements. However, in recent years, this has yielded to the formalism of law.16

The Bank is broken down into three departments, two in Zurich and the third in Berne. These are also functionally divided in terms

of banking services. The services offered in Berne relate to bank notes issue, gold control, and coordination with federal authorities. At the two other departments there is safekeeping of securities, clearing, collection, and settlement, discount of eligible paper, and loan functions of the Swiss Bank. The Bank is also responsible for monetary policy through control of the money supply and open market operations.

Reserves are mandatory for all banks, and are of two types. One is in the form of an interest-free deposit to fight inflation, which the Bank may authorize. Such reserves are a function of the bank's growth level and liabilities.

A second reserve is for the writing off of losses, and is calculated, at a minimum, one-twentieth of a bank's yearly profits. The ceiling on this amount would be one-fifth of paid in capital, or in the case of banks with no paid-in capital, one twentieth of deposits.

The Swiss National Bank does not charge for banking services.

(h) Austria

The Bank of Austria, in similar fashion to other central banks, performs both national economic and monetary policies, as well as the recognized currency services of most central banks. However, under the Austrian system, the central bank issues only bank notes while coins are exclusively issued by the Ministry of Finance.
All credit institutions must maintain reserves. These are uniformly fixed, by law, as a percentage of liabilities, the opposite of the neighboring German system of variable reserves. No interest is paid on reserves.

The Bank and the Ministry of Finance deliver currency free of charge. However, other banking services, such as check clearing, settlement, and miscellaneous interbank exchanges are provided by private institutions rather than by the Bank of Austria. As is generally the case, there is a charge for the services of private institutions.

(1) Greece

In terms of political authority of national banking organizations, the Greek system is the exact opposite of the Federal Reserve. Here the national government has strict control over all banks without exceptions. All financial policy is placed in the Greek Currency Committee. The Bank of Greece has the authority to enforce adherence by the banks to the decisions of the currency committee.

The Bank of Greece is similar to the Federal Reserve in the sense that they are both among only five world central banks in which the state does not have any direct share of ownership. Besides its supervisory authority over policy it performs traditional central banking functions such as settlement and check clearing,

providing currency, transfer of funds, and custodian of the state's foreign assets. The Bank charges a percentage rate fee for settlements and check clearing services.

Reserves are held in two parts. The first is calculated at 20 percent of demand and time deposits and 5 percent of private savings. No interest is paid on these reserves. On the second reserve, which is the same for demand and time, and 3 percent for savings, interest is paid. Current rate is 9.5 percent.\textsuperscript{18}

(j) Mexico

The Mexican Central Bank is owned 51 percent by the Mexican government, the remaining 49 percent held by the credit institutions themselves. The Mexican government's requirements cover all banks.

The Organic Law of the Bank of Mexico\textsuperscript{19} states that the Bank's functions are regulation of currency, clearing, management of reserves held with it by the commercial banks, supervision of compliance by the commercial banks of decisions of the National Banking Commission, and acting as financial agent of the government in foreign transactions and loan matters.

Reserves are a major policy tool in Mexican monetary policy. At present they are set at 37 percent of deposits. The reserves can be divided into two parts; those taken for monetary policy and those

\textsuperscript{18} June 1978 figure provided by Greek Embassy, Washington D.C.

for legal purposes. About one half of all reserves earn interest.

The Bank provides currency, settlement and clearing as well as wire transmission services to the commercial banks. There are charges for all of these services.

(k) Japan

The Bank of Japan is one of the oldest central banks, dating back to 1882. Its origins are in the monetary crisis of the same year, caused by an over-abundance of paper money issued by the several national banks. The Bank ordered the withdrawal of all issue and became the sole source of currency.20/

The Bank has a complex system of variable reserve requirements, which classify banks on the basis of size and function of institution, as well as type of deposit. Function classes range from savings, to agricultural, to "near-banks" that perform only one banking function. No interest is paid on any reserves.

Among its banking services is providing currency, wire transmission, and discounting of bills. No charge is made for these services. For settlement and check clearing there is no direct charge. This is done through a system of clearing balances held by the Bank. Adjustments are simply made in the balances to account for transactions.

The Bank is owned 55 percent by the government, the remainder by the commercial banks. Its directors are all government appointed, and there is no shareholder participation in management.

(20) M.H. de Kock, Central Banking, p.7 (1974).
Canada's banking structure is set up so that all institutions allowed to call themselves banks are under the control of Parliament. This is accomplished by having only twelve banks, each required by law to be chartered by Parliament. These handle savings and commercial transactions. Mortgage, trust, and loan activities are handled by other institutions, known commonly as "near-banks" but not within the bank classification. The system has been relatively stable. In fact, the last bank failure in Canada took place in 1923.

The Bank of Canada does not provide the full range of services provided by other central banks reviewed in this study. Its main responsibility is the control of credit. As such it holds reserves of the chartered banks in two classes of reserves. Cash reserves, held in the form of deposits with the Bank of Canada are set at present at 12 percent for demand and 4 percent for time deposits. Secondary reserves are a complex scheme of deposits in excess of the above cash reserves. Also, on the basis of moral suasion Canadian banks generally are advised to keep an investment in some liquid asset. Reserves are non-interest bearing.

The Bank of Canada provides coin and paper currency at no cost for shipping. However, settlement and clearing is the responsibility of the Canadian Bankers' Association through a network of clearing houses. The Bank of Canada assists in this to a certain degree by supervision at the head offices of the banks and in transmitting net clearing results to the banks. The CBA charges for interbank services.

(21) See Canadian Bankers' Association publications in bibliography.
The statutory scheme of Canadian banking law provides for a revision every ten years. In August, 1978, a revised bill entered its second reading before Parliament. Of relevance to the changes now being contemplated in the United States is the provision in the new bill for a Canadian Payments Association.\(^\text{22}\)/

The CPA would be chartered by Parliament, in much the same way as the twelve chartered banks. All twelve banks would be required to join. The purpose of this facility is to widen the scope of the clearing system and the coordinated banking in Canada.\(^\text{23}\)/ The CPA would not be an agent of the Canadian government.

Originally, the proposal had called for mandatory reserves of all CPA members, but it now appears that this proposal has been deleted. All banks (but not near-banks) under the new legislation will still be required to keep reserves with the Bank of Canada, but these reserves are to be reduced by approximately 2 percent across the board. It might also be pointed out that the near-banks do not have access to the banking services of the Bank of Canada.

\(^{22}\) Bill C-57, 26-27 Elizabeth II, 1977-78.

\(^{23}\) Donald S. Macdonald (Minister of Finance), White Paper on the Revision of Canadian Banking Legislation (1976).
IV. CONCLUSIONS

The central banks chosen for this paper represent the banking systems of the world's most developed, free industrial states. While there are many other central banks abroad, these represented the most advanced that could be readily studied.

Of the twelve central banks considered, eleven operate under a political system in which the national government reaches all banking institutions without the need for a participatory scheme that excludes some commercial banks. The twelfth nation, Canada, merely uses the device of nationally chartered banks exclusively in order to have Parliament supervise all banks. Therefore, whether the reserves are variable or fixed, in all twelve nations they are mandatory for all banks.

In every country where private institutions provide the basic banking services similar to those discussed above for the Federal Reserve, charges are levied for the services. In the cases where the central bank provides the basic banking services, four charge directly and several other require the banks to hold clearing balances which they adjust periodically as transactions are made. Charges are in the form of either flat fees or percentage commissions or both on various transactions.

Interest on reserves held by foreign central banks is not a common feature. Only three nations, Greece, Italy and Mexico pay interest directly. Only Italy pays interest across the board.
on all reserves. Moreover, Mexico pays only on a portion of reserves and Greece only on secondary reserves. Italy at times permits banks to hold reserves in bonds and securities, and in such circumstances, reserves receive the market yield.

The central bank of Belgium allows some reserves to be held in the form of Treasury Securities. Great Britain pays interest on emergency monetary reserves, but these reserves are not a permanent feature. Denmark is among four nations that hold prudential, check clearing or special monetary deposits. It is the only nation studied paying interest on check clearing balances or special monetary deposits.

In Belgium, West Germany, France, Mexico and Greece, banking supervision is pursued by royal or governmental commissions acting in concert with the central bank. The commissions deal mostly with micro-policy, the regulation of individual banks, and leave macro-policy, the national economic regulation, to the central bank. However, there is a thin line separating the commissions and the central banks, and in some cases, the central banks are the enforcers of both micro and macro policy.

Finally, in Great Britain and Canada, while the central banks do not operate in as many areas as the Federal Reserve, coordination with a National Bankers' Association, and the power of moral suasion leads to a tightly regulated banking system.
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Proposed Bank Regulatory Changes And Their Effects On Economic Stability

A Position Paper

by

Anthony M. Santomero

and

Jeremy J. Siegel

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The authors are both Associate Professors of Finance, The Wharton School, University of Pennsylvania. They wish to acknowledge the support of the Rodney White Center for Financial Research.
Introduction

Recent legislative proposals submitted to Congress or presently under discussion offer the potential of substantial changes in the regulatory environment within which commercial banks operate. Hearings have centered upon the alleviation of the so-called "membership problem" facing the Federal Reserve System. During the discussions of possible remedies to the decline in Fed membership a number of substantive changes in regulation have been proposed. Earlier, it was suggested that the improvement of Federal Reserve member's relative position could be obtained by reducing Federal reserve requirements on deposits. A more recent proposal involves the payment of interest on required reserves held at regional Banks. This proposal has been coupled with the elimination of the 1933 prohibition on interest on demand deposits. This coupling was originally viewed as a method of transmitting some of the new found income accruing to the financial institutions directly to their depositors.

In summary, three proposals are presently under consideration, viz.,

(1) a change in the required reserve ratio on member banks
(2) interest payment on required reserves, and
(3) interest payment on demand deposits.

In addition there is the related issue of the appropriateness of different reserve requirements both between members and non-members, and commercial banks and other sight deposit issuers, such as NOW accounts.
(b) Reducing reserve requirements will accentuate the disturbances in the economy caused by a shift in the base or reserve money market (referred to as monetary disturbances). Such a disturbance would occur if commercial bank reserve behavior were to shift or the demand for currency of individuals were to suddenly change.

(c) Paying interest on required reserves has exactly the opposite effect of reduced reserve ratios. It reduces monetary disturbances, while increasing real shocks.

(d) The payment of interest on demand deposits has a similar effect as a reduction in reserves, as it too reduces the severity of monetary disturbances and exacerbates real disturbances.

(e) A combined shift to positive rates of interest on reserves and interest on demand deposits appears to be a counterproductive move from the standpoint of macroeconomic stability. It has the potential of increasing the severity of both monetary and real disturbances to the economy.

(f) A combined shift to lower reserves and positive interest rates on demand deposits would tend to have a stabilizing effect for both disturbances.

(g) Universal reserve requirements could be quite beneficial to economic stability if and only if they were instituted in conjunction with identical definitions of reserve assets for all institutions holding transaction balances.

(h) Universal reserve requirements on transaction balances will cause the economy to be slightly more stable than its present condition, given the current definitions of required reserves and institutional arrangements of check clearing and correspondent banking.
Method of Analysis

The basic framework employed in our research into this question of regulatory change is a general equilibrium model of the financial markets. Three sectors exist in these markets, viz, (a) households, (b) banking or financial institutions, and (c) firms. Each sector's demands and supplies of assets satisfy balance sheet constraints and substitution properties that are well established in the monetary literature. The financial markets themselves are divided into four types of assets, viz. (a) currency, or high powered money, (b) deposits of various types, including demand and time accounts at all financial institutions, (c) bonds issued by firms and the government, and (d) equity, or firm shares. The model determines the rate of interest in the bond and equity markets, and the general level of prices that are consistent with equilibrium.

As noted at the outset, however, our attention centered upon the behavior of the economy when some unexpected disturbance occurs. Of course, if the Federal Reserve had perfect knowledge of all such disturbances, the point would be moot, as they could offset any shifts. In the latter case it has been shown that the monetary authority has sufficient tools to achieve a stable economy. When the price level, and employment levels are only known with a lag and the sources of the disturbances are not known, complete control is not feasible. In this case, the central bank can only operate to minimize the fluctuations in the economy. Alterations in the financial regulations will effect the ability of the Federal Reserve to minimize the destabilizing shocks to the economy. This is the essence of our study.
To analyze the impact of regulatory change on economic stability we consider an exhaustive set of four distinct types of disturbances to the economy. These are:

1. a change in either the demand or supply of money.
2. a change in the market for equity
3. a change in the market for real output
4. a distributional shift between institutions issuing demand balances.

Given the present regulatory structure a disturbance of any of the above types will affect output or prices. The degree of this adjustment is dictated by the interrelationships between markets, and the present regulatory structure.

Next we analyze how the variance of prices would be affected by the proposed changes in regulations. Here variance of price is used as a measure of stability, with output variation or some other indicator of the stability of the underlying economy an equally valid and consistent gauge. The results of the analysis are enumerated above in the summary section.

Concluding Remarks

We believe our study and its results to be particularly relevant to the present hearings. Our work appears to be the only analysis available on the macroeconomic effects of the present proposals. It presents clear cut policy recommendations vis-a-vis the "membership" issue. Specifically it argues that seemingly similar approaches to the reduction of membership cost will have different macro effects. It seems obvious that these differences should be recognized in any regulatory change.

Obviously we have not burdened the committee with the explicit model that achieves these results. However we would be happy to offer our scholarly papers that arrive at these conclusions. Further, any questions you may have or discussion you may wish would be welcome by both of us.