NOW Accounts [1]

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

1976 NOV 12 AM 10: 36

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AMERICAN
BANKERS
ASSOCIATION

1120 Connecticut Avenue, N.W.
Washington, D.C.
20036

EXECUTIVE VICE PRESIDENT

Willis W. Alexander
202/467-4211

~~FB~~
~~DW~~
F.C.
NOW Accounts
#1328

11 November 1976

The Honorable Arthur F. Burns
Chairman
Board of Governors of the
Federal Reserve System
20th & Constitution Avenue, N. W.
Washington, D. C. 20551

Dear Chairman Burns:

I am writing because of concerns expressed by several bankers about a Federal Reserve Board staff study, "Effects of NOW Accounts on 1974-1975 Commercial Bank Costs and Earnings," by John Paulus. We realize the paper is merely a study by one of your staff economists and does not represent an official position of the Board. Nevertheless, the wide publicity given the study by the press, Senator McIntyre, and others, has prompted me to express our concern about its cursory treatment of some important policy issues.

Specifically, the opening section of the paper says that given "the accumulating evidence that NOWs have not significantly reduced commercial bank market shares, or after tax earnings at the aggregate level, it would appear that the NOW account program has been an almost unqualified success." The paper goes on to say "some weaker banks could experience serious financial difficulties if NOW pressures on costs and revenues continue. In the event such difficulties disrupt financial markets, the final verdict on NOWs may be less optimistic." Thus, the attitude of the author seems to be that statewide market shares and the stability of financial markets are the only criteria that should be used to evaluate the NOW account program. We disagree.

The cost burden of NOW accounts is particularly heavy on smaller consumer oriented banks whose market area typically is smaller than that encompassed by statewide boundaries. The aggregation of all markets in a state would give adequate information about local markets only if NOW accounts impinged equally on all banks in all markets, and the innovation had, in fact, spread throughout the state. Neither of these conditions holds.

More importantly, we do not think the problems of individual smaller banks that are hurt by NOW accounts can be summarily dismissed. The banks affected are managed by people who made decisions to serve the needs of their communities under a given set of rules and regulations. They are not responsible for changing the rules; policymakers are. Failure of such institutions for reasons beyond managerial control would be a disservice to the management of these banks and the communities they serve. We believe these institutions deserve due consideration.

We shall continue our own evaluation of the NOW account program. As the Board undertakes its evaluation, we hope it will make a balanced consideration of the problems encountered by all financial institutions and their customers.

Sincerely,

Willis Alexander

Willis W. Alexander

WWA:mfc

9-13-76

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Mr. Chairman---

Paul Nelson, chief of staff of House Banking called to indicate that Reuss has now received letters from three Reserve Bank presidents and that the letters are almost identical.

Paul put forward the thesis that we were co-ordinating the replies and indicated--"we are going to blast you people".

K

Ken G.

cc--Joe Coyne

B-154

DRAFTED BY: Ed Ettin

REVIEWED BY: Dr. Burns
T. Allison
K. Guenther
J. Sernia
N. Bernard

B-154

September 10, 1976

The Honorable Henry S. Reuss
Chairman
Committee on Banking, Currency
and Housing
House of Representatives
Washington, D. C. 20515

Dear Mr. Chairman:

In accordance with the request in your letter of April 19, I am pleased to enclose a paper prepared by a member of the Board's staff entitled "Effects of NOW Accounts on 1974-75 Commercial Bank Costs and Earnings." This study analyzes the effects of the introduction of NOW accounts in Massachusetts and New Hampshire on bank profits and market shares. It also contains some comments on the characteristics of the possible long-run balance that might be achieved with the continued payment of interest on transactions balances, and the transition problems that would be associated with such a development.

I hope that you will find the study helpful. As indicated, it expresses staff judgments, which have not been reviewed or approved by the Board of Governors.

Sincerely yours,

(signed) Arthur F. Burns

Arthur F. Burns

Enclosure
EE:ja
cc: Ed Ettin

HOUSE

Nelson	2129 RHOB	McMahon	~~3156 HOB Annex 2**~~ 2129 RNOB	Secrest	2129 RHOB
Still	2136 "	Weintraub	3154 HOB Annex 2**	Doremus	B-371A "
Fink	B-371A "	Sivon	605 HOB Annex*	Flaherty	2129 "
Dixon	2129 "	Feinberg	605 " " *	D'Arista	2129 "
Prins	212 HOB Annex*	Lewis	3154 HOB Annex 2**	Couch	3154 HOB Annex 2
Northup	B-371A RHOB	Gasper	2222 RHOB	Crews	2129 RHOB
~~Larkin~~					

* N.J. Avenue & C Streets, S.E.
** Independence Avenue & 2nd Street, S.W.

SENATE

~~McLean~~	5300 DSOB	Buckley	5226 DSOB
~~Cluff~~	5310 "	Marcuss	456 RSOB
~~Weber~~	5230 "	Bray	A-719 Annex 3, 119 D St., N.
Abshire	A-522, 119 D St., N.E.	Wahlstrom	1251 DSOB
Henderson	5300 DSOB	Bachrach	5300 "
Marinaccio	5300 DSOB	Jordan	5300 "
Rohner	A-524, 119 D St., N.E.	Brooks	5300 "
Kuttner	5300 DSOB	Paradise	5300 "
~~Smith~~			

JEC

Stark	G-133 DSOB	Krumbhaar	G-133 DSOB	Karlik	G-133 DSOB

Rosenthal's Subcommittee (House Gov't. Opers.)

Barash	B-350A RHOB	Dugger	B-350A RHOB

House BUDGET

Gross	214 HOB Annex*
Teeters	" " " *
Miller	" " " *
Jewell	" " " *

Senate BUDGET

Boyd	208 Carroll Arms Annex
Packer	" " " "

EFFECTS OF NOW ACCOUNTS ON

1974-75 COMMERCIAL BANK COSTS AND EARNINGS

BY

JOHN D. PAULUS *

August 1976

* Staff, Board of Governors of the Federal Reserve System
This study represents a joint effort of several members of the Federal Reserve System staff. First, Ralph Kimball of the Federal Reserve Bank of Boston deserves a special thanks. His assistance was invaluable on matters ranging from defining marginal bank groups to conducting bank interviews. At the Board, Edward Ettin, James Kickline, John Mingo and Perry Quick made particularly valuable contributions and improvements to the final draft. Others who read an earlier draft and made valuable comments include David Lindsey, Ray Lombra and John Williams from the Board and Paul Anderson, Robert White and Mary Chamberlain from the Boston Fed. Jeff Susskind and Rebekah Wright assisted in gathering data and preparing tables, and Mary McLaughlin and Denise Lancaster typed the final as well as earlier drafts. Despite the assistance of these people, I alone am responsible for any remaining errors of judgment or analysis.
NOTE: The judgments and conclusions of this paper are not necessarily those of the Board of Governors of the Federal Reserve System.

CONTENTS

I. INTRODUCTION

In May 1972 the Massachusetts Supreme Court ruled that state law did not prohibit mutual savings banks from offering negotiable orders of withdrawal (NOW) from savings accounts. Following this ruling several state chartered mutual savings banks (MSBs) in Massachusetts began to issue NOW accounts, and, in September, a savings bank in New Hampshire began offering NOWs after determining that New Hampshire law was similar to that of Massachusetts. Although these rulings allowed state-regulated MSBs to participate in the NOW market, federally chartered or insured depository institutions could not--under federal regulations--offer NOWs. The resultant controversy led to congressional legislation--Public Law 93-100--signed on August 16, 1973, authorizing all depository institutions (except credit unions) in Massachusetts and New Hampshire to offer interest bearing deposits on which withdrawals by negotiable order could be made. This legislation thus established a formal experiment in the two states in which limited demand deposit powers were extended to thrifts and the payment of interest on transactions balances was authorized for the first time since 1933.

Regulation and Growth

Regulation of NOW accounts was divided between the Federal Reserve Board, the Federal Home Loan Bank Board, and the Federal Deposit Insurance Corporation. All institutions were authorized to begin offering

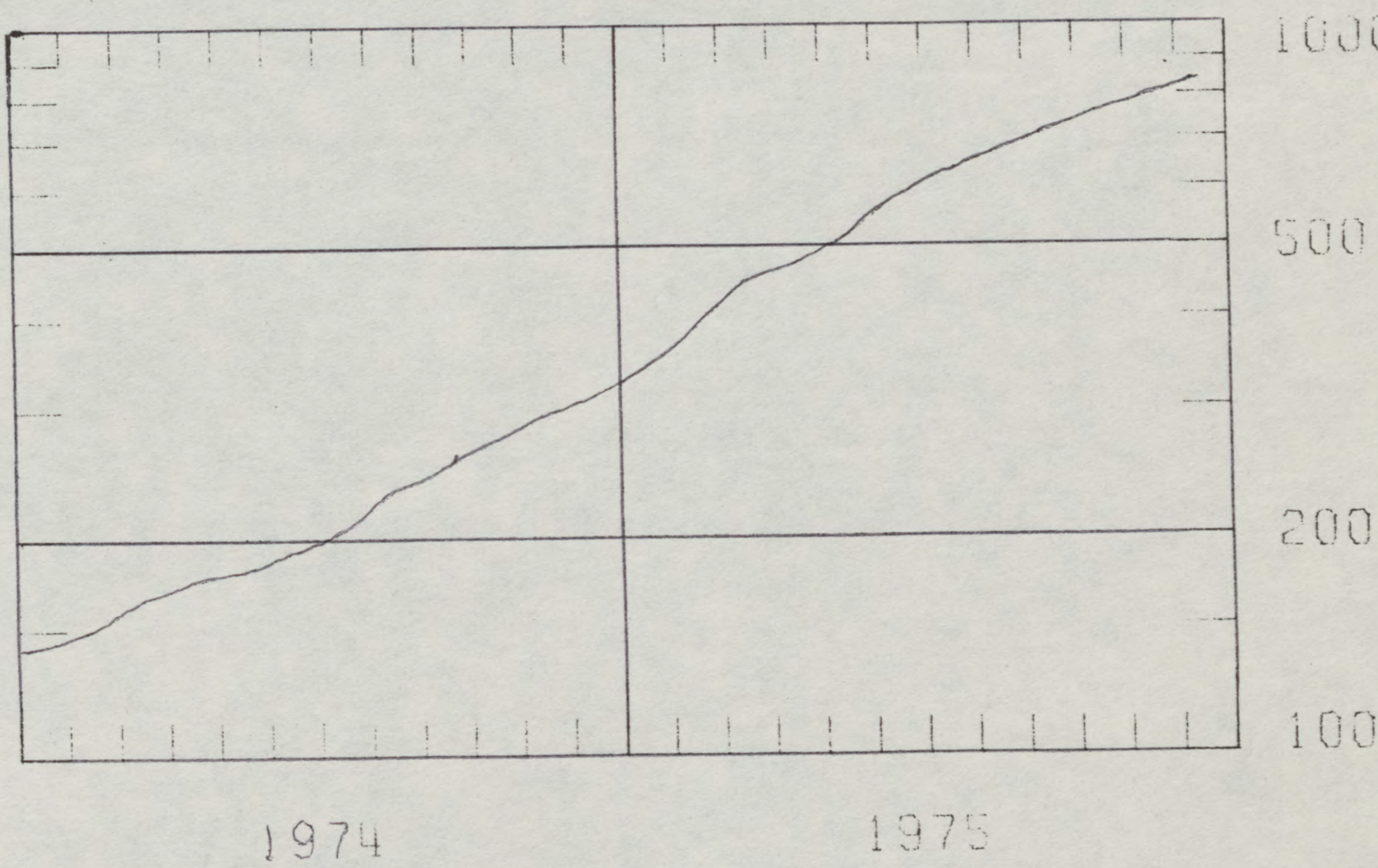
NOWs on January 1, 1974, but NOW accounts were to be issued exclusively to individuals, non-profit organizations and sole proprietorships. Partnerships, corporations, state and local governments, and financial institutions were prohibited from holding NOWs. Because eligible individuals and institutions held an estimated one-third of the $6 billion in demand deposits in Massachusetts and New Hampshire in 1974, this prohibition limited to about $2 billion the maximum level of conversions from commercial bank (CB) demand balances to NOW accounts; of course, NOWs could also attract funds from other financial assets, especially savings deposits.

The three federal agencies imposed an interest rate ceiling of 5 per cent on NOW accounts offered by all institutions, the same as on savings deposits at CBs but one-fourth of a point less than thrifts are permitted to pay on savings deposits. At the end of 1975, 97 per cent of all institutions offering NOWs were paying this 5 per cent ceiling rate of interest.

Congress did not include in the law uniform reserve requirements against NOWs. Because NOWs are technically savings accounts, members of the Federal Reserve System must hold 3 per cent in required reserves against NOW balances, as compared to reserve requirements averaging about 10 per cent on demand deposits. Nonmember banks and thrifts in Massachusetts and New Hampshire hold negligible reserves in non-interest bearing form against both demand deposits and NOW accounts.

The popularity of NOWs with consumers is evidenced by the rapid and steady growth of these accounts. In the first two years of the experiment, NOW balances grew at an average rate of 7-2/3 per cent per month, advancing from $143 million to $839 million. As shown in Figure 1, the monthly growth rates over this period have been quite stable, although during the last half of 1975 the rate of NOW growth declined somewhat, averaging just under 6 per cent per month.

FIGURE 1
NOW BALANCES ON RATIO SCALE
($ millions)



Purpose and Scope

NOW accounts have evolved into a very close substitute for personal checking accounts, thereby eroding CBs traditional monopoly position in the issuance of such accounts. With such erosion, CBs in Massachusetts and New Hampshire have lost the exclusive claim to offering "one-stop banking" to individuals who, for convenience, might be willing to maintain a time or savings account, even at relatively unfavorable interest rates, at an institution that provides checking services. Moreover, the payment of interest on NOW accounts, many of which represent direct conversions of zero-interest demand deposits, has raised the average costs to CBs of acquiring funds.

These factors suggest that NOW accounts could affect the stability and the viability of commercial banking in Massachusetts and New Hampshire as CBs attempt to adjust to the new, more competitive environment. This issue--the stability of commercial banking in the two states during the adjustment period--is the subject of the remainder of this study. Both aggregate and micro data are used to analyze the ongoing adjustment of banks in the two states.

In Sections II and III, a broad view is taken of industry wide developments in banking in 1974 and 1975. Shifts in market shares are reviewed, and the hypothesis that the spread of one-stop banking to thrifts might cause CBs to lose significant amounts of demand related funds--especially small time and savings deposits--is examined. Rough estimates of the direct effect of NOW accounts on CB costs and earnings since January 1974 are also developed and discussed.

In Section IV the emphasis shifts to the adjustment problem of selected individual CBs. In any industry, it is the "marginal" firms--those firms with relatively high costs, or inadequate revenues--that determine the flexibility of the industry in adjusting to changes in the competitive and regulatory environment. The effect of NOW accounts on costs and earnings of 40 such marginal banks in the two states are therefore analyzed for 1974 and 1975. Moreover, adjustments in asset portfolios are considered to determine whether these banks have attempted to offset lower earnings by undertaking more risky investments.

In Section V, characteristics of the steady state--the period after which the industry has had ample time to adjust fully to NOW accounts--are discussed, including implications for increased efficiency in the allocation of resources and the extent to which the public benefits, on balance, from the issuance of NOW accounts. In addition, future CB adjustment problems are considered as NOW balances continue to grow toward some equilibrium level.

Summary and Conclusions

Although NOWs represent a relatively expensive source of funds, banks began to compete aggressively for such deposits in 1975, despite low rates of return on money market instruments and weak demand for business loans. As a result, NOW related flows of funds have had only a modest effect on the CB share of total deposits in Massachusetts and New Hampshire. By the end of 1975, two full years after the NOW experiment began, households in the two states had converted an estimated $370 million in CB demand balances to NOW accounts at thrifts. However, there is no evidence that significant flows of time and savings deposits have accompanied this demand outflow from CBs. Thus, NOW induced shifts in deposit flows, confined mainly to demand deposits, appear to have reduced the CB share of deposits in the two states--which total nearly $40 billion--by about one percentage point.

The effects of NOWs on aggregate CB costs and earnings are limited by the relatively small size of the NOW market in the two states--demand balances eligible for conversion to NOW accounts, for example, represent less than 15 per cent of total deposits at CBs. In 1974, higher costs and deposit outflows associated with NOWs reduced aggregate CB after tax earnings an estimated 2-1/2 per cent. Heightened consumer awareness of NOWs by 1975 caused an acceleration in the growth of these deposits, resulting in substantial increases in bank costs of funds. As a result, the estimated earnings reduction attributable to NOWs in 1975 was more than twice that of 1974.

It is argued in the final section that after all adjustments are complete--a process that may take several more years--CB costs of acquiring transactions balances could ultimately decline as a result of removing the restriction against the payment of interest on such funds. Given this expectation--which implies that both consumers and banks will be better off in the long run--and the accumulating evidence that NOWs have not reduced significantly either CB market shares or after tax earnings at the aggregate level, it would appear that the NOW experiment has been an almost unqualified success to date.

However, an examination of the earnings of those banks that appear to be most vulnerable to competitive pressures from NOWs--the "marginal" banks--revealed that the earnings performance of such banks deteriorated significantly in 1975 relative to that of other banks in the two states. In the next few years the earnings prospects for many marginal banks in Massachusetts and New Hampshire, which tend on average to be relatively small, may worsen as conversions and outflows of demand deposits continue. Though NOWs may be only one of many contributing factors, some weaker banks could eventually experience serious financial difficulties if NOW pressures on costs and revenues continue. In the event such difficulties should disrupt financial markets, the final verdict on NOWs may be less optimistic than the 1974-75 aggregate figures would suggest. However, the likelihood of such disruptions is probably small because the link between the disappearance or enforced merger of a limited number of weak banks, which is an uncertain event itself, and the stability of financial markets, is very difficult to establish.

II. FLOWS OF FUNDS AND MARKET SHARES

The share of the NOW market held by CBs, shown in Table 1, has risen steadily since the beginning of the NOW experiment, reaching 43 per cent by the end of 1975. MSBs held 46 per cent of all NOW balances at that time, while savings and loan associations and cooperative banks (S&Ls and Coops) held the remaining 11 per cent. During 1974, CBs and MSBs each captured 41 per cent of net new NOW balances, with S&Ls and Coops attracting 18 per cent. In contrast, in 1975 CBs acquired 56 per cent of the increase in NOWs, while MSBs and S&Ls and Coops received 33 and 11 per cent, respectively, of net new inflows.

TABLE 1

OUTSTANDING BALANCES AND SHARES - NEGOTIABLE ORDERS OF WITHDRAWAL (NOWs)
(in thousands of dollars)

MONTH ENDED	TOTAL OF ALL OFFERING INSTITUTIONS	COMMERCIAL BANKS TOTAL	COMMERCIAL BANKS MASS.	COMMERCIAL BANKS N.H.	SHARE OF TOTAL NOWS	MUTUAL SAVINGS BANKS TOTAL	MUTUAL SAVINGS BANKS MASS.	MUTUAL SAVINGS BANKS N.H.	SHARE OF TOTAL NOWS	SAVINGS & LOAN ASSOCIATIONS TOTAL	SAVINGS & LOAN ASSOCIATIONS MASS.	SAVINGS & LOAN ASSOCIATIONS N.H.	SHARE OF TOTAL NOWS
1972--Sept.	11.094					11,094	11,094						
Oct.	22,386					22,386	22,386						
Nov.	34,823					34,823	34,363	460					
Dec.	45,272					45,272	44,522	750					
1973--Jan.	60,726					60,726	59,661	1,065					
Feb.	73,451					73,451	71,975	1,476					
Mar.	86,118					86,118	84,162	1.956					
Apr.	94,606					94,606	92,341	2,265					
May	102,045					102,045	99,633	2,412					
June	108,381					108,381	105,688	2,693					
July	113,418					113,418	110,486	2,932					
Aug.	117,005					117,005	113,852	3,153					
Sept.	120,223					120,223	116,259	3,964					
Oct.	130,361					130,361	125,873	4,488					
Nov.	136,872					132,872	131,795	5,077					
Dec.	143,254					143,254	138,028	5,226					
1974--Jan.	143,190	2,556	2,274	282	.02	139,779	134,832	4,947	.98	855	855	--	.01
Feb.	150,447	4,338	3,857	481	.03	143,764	138,453	5,311	.96	2,345	2,345	--	.02
Mar.	165,157	6,588	5,916	672	.04	154,007	147,845	6,162	.93	4,562	4,325	237	.03
Apr.	174,682	9,689	8,458	1,231	.06	157,412	150,309	7,103	.90	7,581	6,913	668	.04
May	180,637	11,052	9,296	1,756	.06	159,591	151,510	8,081	.90	9,994	8,351	1,143	.05
June	191,229	13,771	11,156	2,615	.07	164,733	155,946	8,787	.86	12,725	11,089	1,636	.07
July	204,646	17,919	14,175	3,744	.09	171,503	161,544	9.959	.84	15,224	13,223	2,001	.07
Aug.	232,386	32,955	28,450	4,505	.14	180,335	169.119	11,216	.78	19,096	16,781	2,315	.08
Sept.	249,033	39.253	33,597	5,656	.16	187,721	175,340	12,381	.75	22,059	19,314	2,745	.09
Oct.	270,813	46,776	40,245	6,531	.17	197,758	184,830	12,928	.73	26,279	23,316	2,968	.10
Nov.	293,305	55,994	48,563	7,431	.19	206,764	192,577	14,187	.71	30,547	26,689	3,858	.10
Dec.	312,576	65,249	56,989	8,260	.21	213,661	200,083	13,578	.68	33,666	29,747	3,919	.11
1975--Jan.	339,982	82,861	73,517	9,344	.24	220,725	206,797	13,928	.65	36,396	32,369	4,027	.11
Feb.	385,190	107,481	96,647	10,481	.28	236,580	221,506	15,074	.61	41,482	37,215	4,267	.11
Mar.	449,638	137,519	124,706	12,813	.31	262,797	246,259	16,538	.58	49,322	43,980	5,342	.11
Apr.	472,864	150.999	136,165	14,834	.32	268,571	250,780	17,791	.57	53,294	47,185	6,109	.11
May	514,018	172,653	155,318	17,335	.34	283,322	263,978	19,344	.55	58,043	51,388	6,655	.11
June	580,331	210,838	185,923	24,195	.36	304,633	283,134	21,499	.53	64,860	57,315	7,545	.11
July	630,402	233,513	201,607	31.096	.37	327,417	303,805	23,612	.52	69,472	61,554	7,918	.11
Aug.	670,790	256,992	217,936	39,056	.38	337,684	213,117	25,567	.50	76,114	67,519	8,595	.11
Sept.	713,419	289,308	235,029	45,279	.39	351,612	324,005	27,607	.49	81,499	72,407	9,092	.11
Oct.	761,967	305,214	254,821	50,393	.40	368,271	338,580	29,691	.48	88,482	78,785	9,697	.12
Nov.	796,533	325,519	271,691	53,828	.41	378,792	347,145	31,647	.48	92,222	81,863	10,359	.12
Dec.	839,339	359,023	302,112	56,911	.43	386,560	356,319	30,241	.46	93,756	84,168	9,598	.11

The success of CBs in 1975 in attracting or retaining NOW funds can be attributed in part to the large increase in the number of offering institutions relative to that of MSBs. In 1975, the number of CBs offering NOW accounts increased from 64 to 134, while the number of offering MSBs rose only from 157 to 175. Though a large number of S&Ls and Coops entered the NOW market in 1975, their ability to attract NOW balances has been limited by the relatively small size of these institutions in the two states.

Source of NOW Funds

Establishing the source of NOW funds--whether demand deposits, time and savings deposits, or other--is of considerable importance in examining NOW related market share developments and, as will be shown in Section III, in estimating the aggregate earnings impact of NOWs on CBs. One important type of evidence on this matter concerns the behavior of active NOW accounts and the proportion of NOW funds in active and inactive accounts. Draft activity against active NOW accounts (i.e., those with at least one draft drawn in a given month) has increased gradually during the experiment and now averages about 11 drafts per month. Since the average number of checks written against personal checking accounts in New England in 1974 was about 14, this suggests that active NOW accounts are being used primarily as checking accounts.

As a first approximation it thus seems reasonable to assume that funds in active NOW accounts were acquired largely from demand deposit balances. If, as seems plausible, inactive NOW funds originated primarily in sources other than demand deposits--especially time and savings deposits--then total active NOW balances can serve as an estimate of the amount of NOW funds that were converted, or diverted, from demand deposits.

Though there are no data on active and inactive balances, estimates can be obtained from data on the number of active and inactive NOW accounts in the two states. In December 1975, there were 764,984 NOW accounts at banks and thrifts in Massachusetts and New Hampshire, of which 157,136--or 21 per cent--were inactive.1/ If the average balance in these inactive accounts was equal to the average balance in savings accounts in CBs in New England, which is $1100, then inactive balances totaled some $170 million in December, or about 20 per cent of total NOW balances.2/ This leaves $670 million, or about 80 per cent,

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1/ Of course, the 157,136 inactive accounts include some that were active in earlier months; likewise, some of the accounts that were active in December were inactive in one or more previous months. However, it is believed that the number of drafts written against each account is relatively stable from month-to-month, so that membership in the two classes of accounts--active and inactive--is also relatively stable. A necessary (though not sufficient) condition for stable membership in the two classes is that the percentage of inactive accounts must be relatively stable. This condition is satisfied adequately in the two states where the percentage of inactive accounts has fluctuated narrowly from month-to-month while declining from 26 per cent in mid-1974 to 20 per cent in December 1975.

2/ Passbook savings balances in thrifts average between $2000 and $3000 in Massachusetts and New Hampshire. However, those savings balances that were converted to NOWs can be expected to be much smaller than this average because of the one-fourth percentage point loss in earnings which becomes significant for large accounts. Moreover, many of the larger savings accounts at thrifts are held by businesses and are therefore ineligible for conversion to NOWs. Thus, the $1100 figure is applied to both thrifts and CBs.

in active balances. This estimate of the proportion of NOW balances attracted from demand deposits is similar to those offered by banking industry representatives in Massachusetts.

In Table 2, estimated active and inactive balances are shown for CBs and thrifts in December 1975. As shown in column 3, thrifts held an estimated $370 million in active NOW balances in December. These funds, serving largely as checking balances,[3/] appear to have been obtained primarily from CB demand balances. Of the $110 million in inactive accounts at thrifts, an undetermined part was no doubt obtained from CB time and savings deposits, with most of the remainder representing conversions from time and savings at thrifts. This

TABLE 2
ESTIMATED ACTIVE AND INACTIVE NOW BALANCES
($ in millions)
December 1975

Massachusetts and New Hampshire	NOW Balances	Estimated Inactive Balances	Estimated Active Balances
CBs	359.0	61.4	297.6
MSBs	386.6	89.6	296.9
S&Ls & Coops	93.8	21.8	71.9
TOTAL	839.3	172.8	666.5

3/ Draft activity against active NOW accounts at thrifts averages about 9½ in the two states, only slightly below the average at CBs.

suggests that approximately $400 million of NOW balances currently held by thrifts originated in CB deposits.

Market Shares of Total Deposits

The direct effect of NOW accounts on market shares in the two state area, where deposits at CBs and thrifts total nearly $40 billion, thus amounts to a one percentage point reduction in the 45 per cent share held by CBs. Although this represents a relatively modest reduction in the market share of CBs, the indirect effect of NOWs on such shares must also be considered before any judgment can be reached on whether major shifts are under way.

This indirect effect involves the spread of convenient one stop banking to thrifts. By permitting thrifts to issue what is essentially a demand deposit, CBs could conceivably lose large amounts of time and, especially, savings deposits as demand deposit funds are diverted to thrifts. Commercial bankers are particularly worried about this possibility in view of the one-fourth percentage point advantage thrifts can offer on passbook savings.

The evidence on this issue indicates that no such shift in deposits between institutions has occurred, as yet. In the upper half of Table 3 market shares of passbook savings excluding NOWs are shown for the last four Call Report dates, beginning in December 1973, just before the NOW experiment began. As shown in the table, CBs' share of the passbook savings market, in both Massachusetts and New Hampshire, has actually grown during the NOW experiment. In Massachusetts the

TABLE 3

MARKET SHARES OF DEPOSITS HELD BY MAJOR DEPOSITORY
INSTITUTIONS IN MASSACHUSETTS AND NEW HAMPSHIRE

	June 1970	June 1972	Dec 1973	June 1974	Dec 1974	June 1975
	PASSBOOK SAVINGS EXCLUDING NOWs					
Massachusetts (dollars in millions)	13,605	13,815	12,906	13,680	12,882	13,695
Percentage held by						
CBs	11.9	15.5	16.7	16.5	17.7	19.1
MSBs	79.5	75.2	73.8	74.6	73.3	72.6
S&Ls	8.6	9.3	9.5	8.9	8.9	8.3
New Hampshire (dollars in millions)	1,632	1,702	1,784	1,835	1,807	1,937
Percentage held by						
CBs	16.7	24.7	27.1	29.0	29.5	30.0
MSBs	68.3	59.9	57.8	55.9	55.4	54.9
S&Ls and coops	15.0	15.4	15.1	15.1	15.1	15.1
	TOTAL DEPOSITS					
Massachusetts (dollars in millions)	21,886	26,856	30,771	31,302	31,819	32,273
Percentage held by						
CBs	43.8	43.0	45.8	46.4	46.5	43.7
MSBs	49.6	50.3	47.8	47.2	47.1	49.5
S&Ls	6.6	6.7	6.4	6.5	6.4	6.8
New Hampshire (dollars in millions)	2,242	2,850	3,326	3,430	3,462	3,685
Percentage held by						
CBs	36.5	41.3	42.5	42.7	42.9	41.9
MSBs	50.3	44.9	43.7	43.3	42.8	43.5
S&Ls and coops	13.2	13.8	13.9	14.1	14.3	14.6

NOTE: MSB and CB data are from Assets and Liabilities of Commercial and Mutual Savings Banks (FDIC) with the exception of Massachusetts MSB data which were obtained from the NAMSB in New York. S&L data are from Monthly Financial Data (FSLIC).

share of passbooks held by CBs increased from 16.7 to 19.1 per cent between December 1973 and June 1975, while New Hampshire CBs have increased their share of this market from 27.1 to 30.0 per cent during this period. CBs have made significant gains in the passbook savings market during the last twenty years, and this evidence suggests that NOW accounts have not significantly retarded this progress.

Comparisons of total market shares are of limited value, since CBs, unlike thrifts, obtain a relatively large and variable part of their deposits from the issuance of large Certificates of Deposit. Data on total deposits are, nevertheless, presented in the bottom half of Table 3. Although the CB share of total deposits declined from 46.4 to 43.7 per cent between mid-1974 and mid-1975, this share remains nearly a percentage point above its June 1972 level--recall that NOW accounts have been issued by MSBs in the two states since mid-1972. In New Hampshire, the market share of CBs has remained relatively stable over the 1974-75 period, as CBs in that state have successfully protected the gains made in market shares in the early seventies.

On the basis of this evidence it appears that, to date, no significant shifts have occurred in market shares beyond those arising directly from transfers of CB deposits into active NOW accounts at thrifts. However, the possibility of such a shift, occurring on a delayed basis, cannot be totally ruled out, particularly if consumers adjust slowly to changing conditions in financial markets.

III. EFFECTS OF NOW ACCOUNTS ON AGGREGATE COMMERCIAL BANK COSTS, EARNINGS, AND PORTFOLIOS: 1974-1975

In attempting to establish a permanent share of the NOW market, CBs in Massachusetts and New Hampshire have absorbed higher costs through the conversion of demand deposits to NOW accounts and have thus experienced a reduction in net earnings. Moreover, CB net earnings have been further reduced by the loss of relatively profitable demand deposit funds to thrifts offering NOWs. Estimates of the effect of NOWs on aggregate CB earnings must therefore include both the inhouse cost of converting noninterest bearing demand deposits to NOWs, as well as earnings reductions associated with NOW related outflows of demand deposits.

In the remainder of this section rough estimates are produced which, it should be emphasized, are indicative only of basic magnitudes. For reasons to be discussed later, these estimates are probably biased in the sense that the true depressing effect of NOWs on CB earnings is more likely to be smaller than the estimates, rather than larger.

Incremental Costs of NOWs

In estimating the added costs to CBs of acquiring and retaining NOW funds, costs of converting time and savings deposits to NOWs are ignored, since such costs are likely to be small. Thus, incremental costs are calculated by multiplying estimated NOW balances at CBs which were converted from demand deposits by the difference between the average cost of NOW funds and that of demand deposit funds. For this purpose, active NOW balances at CBs, as calculated in Section II, will be used to estimate the level of conversions from demand deposits to NOWs.[4/]

For nonmember banks the average cost of NOW funds is equal approximately to the sum of the interest payment, which averages

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4/ In equating conversions of demand deposits to estimated active NOW balances, the consolidation of savings and demand deposit accounts into one active NOW account creates a minor problem, since treating the balance in the active NOW account as originating in a demand deposit causes an upward bias in the estimated level of demand deposit conversions. Because average NOW balances at CBs are significantly higher than at thrifts--$1600 at CBs to $900 at thrifts--it might appear that the effect of account consolidation on average NOW balances at CBs is large. However, this is somewhat misleading, since NOW accounts at CBs include conversions of so called D/B/A--"doing business as"--demand deposit accounts of sole proprietorships. These accounts typically carry very large balances ranging up to $50,000 and more. According to knowledgable observers, most of these D/B/A accounts have been converted to NOWs, thereby raising NOW average balances relative to those of demand deposits. For a few CBs whose D/B/A accounts were examined, average NOW balances after excluding D/B/A accounts were much smaller and more consistent with average demand deposit balances. Thus, the effect on average balances of consolidating savings and demand deposit accounts into one active NOW account may be quite small, and active NOW balances, as calculated in Section II, probably serve as a reasonably accurate, though slightly biased estimate of demand deposit conversions.

nearly 5 per cent, and the net cost of servicing NOW accounts. This latter cost consists mainly of expenditures on account maintenance (statement preparation, etc.) and costs associated, to a lesser extent, with clearing drafts and handling deposits to NOW accounts. For Federal Reserve members, the NOW cost is equal to this sum, less the earnings from funds released by the lower required reserve ratio on NOWs relative to demand deposits.

The per dollar marginal cost of demand deposit funds is approximately equal to the net cost of servicing demand deposit accounts. This service cost is similar to that of NOW accounts, though probably slightly smaller because a higher proportion of CBs offer free checking than offer free NOWs. If the service cost differential is ignored because of its relative smallness, the incremental cost of NOW funds converted from demand deposits is equal to the rate of interest on NOWs minus, where applicable, the additional earnings from lower reserve requirements against NOWs.

In calculating incremental costs, the interest rate on NOWs is set at 5 per cent and the 3 month Treasury bill rate is used to measure earnings from lower reserve requirements for member banks. These estimated costs are presented in Table 4 on a monthly basis beginning in January 1974.[5/] For 1974, the estimated incremental cost of NOWs totaled $830,000, while for 1975, this total is $9.3 million, reflecting the large growth in NOW balances at CBs this past year. In 1974, before tax CB earnings in Massachusetts and New Hampshire totaled $194 million, while in 1975 such earnings totaled $124 million; thus estimated incremental costs were about equal to one-half per cent of 1974 earnings, while 1975 incremental costs are estimated to be about 7½ per cent of such earnings. By 1975 year-end, moreover, incremental costs were equal to about $14 million at an annual rate ($1.182 million times 12), or about 11 per cent of 1975 earnings.

As noted earlier, however, there are several reasons why these estimates probably overstate actual incremental costs. First, the small savings on service charges of NOWs relative to demand deposits are ignored and, second, active balances are used to estimate demand deposit conversions and this estimate is biased upward. Also, the consolidation of savings and demand deposit accounts into a single NOW account reduces CB's costs, since the maintenance cost of a NOW account is smaller than the sum of the costs of maintaining separate demand and savings deposit accounts.

5/ Symbolically, the per dollar NOW cost for a Federal Reserve member bank can be expressed as:

$$c_n = i_n + s_n - .07\ r$$

where i_n is the interest rate paid on NOWs, s_n is the annual cost per dollar of servicing a NOW account, r is rate of interest on some asset into which the funds derived from the lower NOW reserve requirements will be invested, and the constant .07 is the difference between the average reserve requirement against demand deposits and NOW accounts. If s_n is ignored on the grounds that NOW service costs are similar to those of demand deposits, the incremental cost of NOW funds is equal to $i_n - .07\ r$ for Federal Reserve members, and to i_n for nonmembers. These expressions are used in calculating estimated costs in Table 4.

TABLE 4
ESTIMATED INCREMENTAL COSTS TO CBs OF NOW ACCOUNTS
(in thousands $)

	MEMBER BANKS			NONMEMBER BANKS			
	Active Balances	Monthly Incremental Cost per Dollar	Incremental Cost	Active Balances	Monthly Incremental Cost per Dollar	Incremental Cost	TOTAL CB Incremental Cost
1974-Jan	1,215.5	.00371	4.5	519.9	.00417	2.2	6.7
Feb	1,129.5	.00375	4.2	1,412.2	.00417	5.9	10.1
Mar	2,010.1	.00370	7.4	2,685.9	.00417	11.2	18.6
Apr	2,770.8	.00369	10.2	4,392.6	.00417	18.3	28.5
May	3,148.1	.00367	11.6	4,704.0	.00417	19.6	31.2
Jun	4,279.7	.00360	15.4	5,691.9	.00417	23.7	39.1
Jul	6,783.7	.00371	25.2	7,032.3	.00417	29.3	54.5
Aug	12,588.0	.00366	46.1	7,838.6	.00417	32.7	78.8
Sep	11,554.0	.00368	42.5	16.528.0	.00417	68.9	111.4
Oct	11,524.0	.00374	43.1	18,815.0	.00417	78.5	121.6
Nov	15,756.0	.00372	58.6	21,449.0	.00417	89.4	148.1
Dec	19,994.0	.00375	75.0	25,168.0	.00417	104.9	179.9
							828.9
1975-Jan	31,248.0	.00379	118.4	29,175.0	.00417	121.7	240.1
Feb	46,098.0	.00384	177.0	34,810.0	.00417	145.2	322.2
Mar	62,754.0	.00384	241.0	45,720.0	.00417	190.7	431.6
Apr	70,121.0	.00383	268.6	51,462.0	.00417	214.6	483.2
May	80,021.0	.00386	308.9	60,001.0	.00417	250.2	559.1
Jun	103,083.0	.00386	397.9	68,747.0	.00417	286.7	684.6
Jul	118,220.0	.00381	450.4	75.699.0	.00417	315.7	766.1
Aug	127,962.0	.00379	485.0	83,326.0	.00417	347.5	832.5
Sep	140,017.0	.00379	530.7	92,286.0	.00417	384.8	915.5
Oct	153,315.0	.00381	584.1	99,918.0	.00417	416.7	1,000.8
Nov	163,813.0	.00385	630.7	107,302.0	.00417	447.4	1,078.1
Dec	183,221.0	.00385	705.4	114,385.0	.00417	477.0	1,182.4
							9,325.0

Reductions in Earnings from Demand Deposit Outflows

The second way in which NOW accounts can reduce CB earnings is through the loss to thrifts of funds which would otherwise have provided positive net earnings for CBs. As noted earlier, the major identifiable loss of CB funds amounts to about $370 million in demand deposit balances through December 1975.

In attempting to estimate earnings reductions at CBs attributable to NOW induced outflows of funds, active NOW balances at thrifts are used to approximate demand deposit outflows. Savings deposit outflows, which are essentially unknown, are ignored because the earnings from such funds would have been small, especially in 1975 when market interest rates were low, relative to those of demand deposits.

For nonmember banks, per dollar earnings on demand deposits are equal to the average yield on invested funds minus the net cost of acquiring such funds (in the case of demand deposits, the cost of servicing an average account).[6/] For Federal Reserve member banks, net earnings on demand deposit funds are equal to the average yield on invested funds multiplied by 0.9 (the proportion, on average, of each demand deposit dollar that can be invested after reserve requirements are met) minus the net cost of acquiring funds.[7/]

6/ Of course, nonmember banks maintain small precautionary reserves against deposits. Since such reserves are negligible, they are ignored in all calculations

7/ Symbolically, net demand deposit earnings for member banks are expressed by $rD(1-rr) - sD = [r(1-rr) - s]D$, where r is the yield on invested funds, rr is the average reserve requirement against demand deposits, s is the service cost per dollar of demand balances, and D is the stock of demand deposits. This expression also holds for nonmember banks, of course, with $rr = 0$.

Studies by Donald Hester and James Pierce indicate that a high proportion of demand deposit funds are invested in short-term market securities; thus the Treasury bill rate was used to measure the yield on demand deposit funds lost to thrifts.8/ The average cost of servicing a demand deposit account was, somewhat arbitrarily, set at 3 per cent of the average balance. This rough estimate is based on functional cost data from the Federal Reserve Bank of Boston. These data indicate the cost of servicing a checking account in New England averages between 3 and 4 per cent. Since a substantial portion of CBs in Massachusetts and New Hampshire offer free checking (implying only a small part of servicing costs are born by customers), 3 per cent was chosen as the average net cost of servicing such deposits.9/

Estimates of the earnings reduction attributable to NOW induced demand deposits outflows are presented in Table 5. For each month the estimated total outflow is shown for both member and nonmember banks. These outflows are cumulative--that is, they include all funds lost in previous months as well as those lost in the current month. For both member and nonmember banks, estimated outflows are multiplied by monthly per dollar earnings on demand deposit funds to obtain an

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8/ See Hester, Donald and James L. Pierce, Bank Management and Portfolio Behavior, Yale University Press, 1975.

9/ This method of calculating demand deposit earnings implies the marginal return on demand balances exceeds the average return on all balances. Although for a hypothetical bank issuing only one type of deposit, the marginal return should be below the average return, such a relationship need not hold for any particular type of deposit for banks issuing more than one type of deposit.

TABLE 5
ESTIMATED LOST EARNINGS FROM DEMAND DEPOSIT OUTFLOWS
(in thousands $)

	MEMBER BANKS			NONMEMBER BANKS			CB EARNINGS
	Cumulative Estimated Outflows	Monthly Earnings Per Dollar	Lost Earnings	Cumulative Estimated Outflows	Monthly Earnings Per Dollar	Lost Earnings	Reduction from Outflows
1974-Jan	94,209	.00332	312.4	17,735	.00396	70.3	382.7
Feb	95,314	.00279	266.4	17,959	.00338	60.8	327.2
Mar	103,085	.00349	359.7	19,456	.00415	80.8	440.6
Apr	105,906	.00367	388.9	20,026	.00436	87.3	476.1
May	107,994	.00382	412.8	20,478	.00453	92.7	505.5
Jun	111,187	.00361	401.3	21,121	.00429	90.6	491.8
Jul	116,941	.00331	387.5	22,264	.00396	88.2	475.7
Aug	122,692	.00406	497.9	23,404	.00479	112.0	609.9
Sep	127,487	.00377	480.9	24,368	.00447	108.9	589.8
Oct	135,191	.00293	396.5	25,838	.00354	91.4	487.9
Nov	143,460	.00319	457.5	27,469	.00382	104.9	562.4
Dec	151,598	.00288	437.2	28,949	.00348	100.8	538.1
							5,887.6
1975-Jan	155,605	.00237	368.7	28,376	.00291	82.6	451.3
Feb	170,420	.00169	287.5	31,075	.00215	66.9	354.4
Mar	195,432	.00166	324.0	35,646	.00212	75.6	399.6
Apr	206,168	.00177	365.0	37,647	.00225	84.5	449.5
May	219,731	.00149	326.6	40,128	.00193	77.4	404.0
Jun	236,247	.00139	329.5	43,193	.00183	78.9	408.4
Jul	252,305	.00212	535.6	46,079	.00264	121.5	657.1
Aug	257,973	.00235	605.5	47,222	.00289	136.3	741.8
Sep	276,384	.00229	632.2	50,622	.00282	142.7	774.9
Oct	293,152	.00206	604.1	53,729	.00257	137.9	742.1
Nov	303,838	.00160	486.4	55,725	.00206	114.6	601.1
Dec	311,801	.00163	507.6	57,082	.00209	119.1	626.7
							6,611.0

NOTE: Outflows from member and nonmember CBs are assumed to be proportional to market shares of demand deposits (averaged over each year) of these banks. For example, if member CBs held 80 per cent of demand deposits in a given year, then 80 per cent of active balances at thrifts for that year are assumed to have come from member banks and the remaining 20 per cent from nonmembers.

estimate of earnings lost each month. For 1974, these estimated earnings reductions totaled $5.9 million, which is much larger than the 1974 estimate of incremental costs from Table 4. This, of course, reflects the fact that thrifts--especially MSBs--held a large percentage of active NOWs in 1974. The 1975 estimated earnings reduction from demand deposit outflows, shown at the bottom of Table 5, totaled $6.6 million.10/

After Tax Reduction in Earnings

Adding the estimates of incremental costs of conversion of demand deposits to NOWs at CBs to the reduced earnings from demand deposit outflows from CBs to thrifts yields a rough estimate of the total before tax reduction in earnings attributable to NOW accounts. For 1974 this total was $6.7 million, while for 1975 the total was $15.9 million.

To obtain an after tax reduction in earnings it is necessary to reduce these figures by the amount of the tax savings accruing from lower CB earnings. In 1974 more than 90 per cent of Massachusetts and New Hampshire CBs had before tax earnings exceeding $25,000. The marginal tax rate for these banks was therefore 48 per cent, while for the remaining banks the marginal rate was either 25 or zero per cent, depending on whether earnings were positive or negative. The weighted

10/ Concerning the robustness of these estimates to changes in the assumed average balance in inactive accounts, if instead of $1100 this average was twice as large--$2200--the earnings reduction from demand deposit outflows would have been about 30 per cent smaller. For example, assuming a $2200 average balance in inactive accounts at thrifts reduces estimated active balances from $370 million to $260 million in December 1975. Thus, earnings reductions from demand deposit outflows would be only 26/37, or about 70 per cent, of those shown in Table 5 for that month.

average of these marginal rates, with weights equal to the proportion of banks in each class, is equal to about 44 per cent. Reducing the estimated \$6.7 million 1974 earnings reduction by this amount produces an after tax reduction in earnings of \$3.8 million. Since after tax profits in Massachusetts and New Hampshire totaled \$142 million in 1974, this represents a reduction in total after tax earnings of a little over 2½ per cent.

For 1975 the weighted average marginal tax rate for Massachusetts and New Hampshire banks was 40 per cent. Reducing the \$15.9 million 1975 before tax earnings reduction by this factor thus produces an after tax reduction of \$9.5 million. Total after tax earnings in the two NOW states declined by \$35 million to \$107 million in 1975. NOWs thus appear to account for a little more than one-quarter of the earnings drop in the two states last year.

IV. ADJUSTMENT PROBLEMS OF INDIVIDUAL BANKS

Analysis of aggregate data suggests that at worst, industry-wide earnings in Massachusetts and New Hampshire may have been depressed by a few percentage points in 1974 and 1975 by the introduction of NOW accounts. Consequently, the industry does not appear to be experiencing particularly serious adjustment problems. However, aggregate data can often conceal important information. In particular, when an industry is adjusting to a change in basic costs or revenues, certain segments of that industry--those so-called marginal firms--may suffer disproportionately high losses of earnings and capital. The adjustment experience of these firms can often reveal far more about the stability of the industry than aggregate data.

The remainder of this section is therefore devoted to a study of costs, earnings, and portfolio adjustments of selected banks whose earnings and capital positions appear to be most vulnerable to NOW related changes in costs and revenues. The banks selected for special attention--40 of the 226 banks in the two states--belong to at least one of the following categories: (1) "high ratio" banks, defined as those banks having 10 per cent or more of total deposits in NOW accounts in June 1975, (2) "runoff" banks, defined as those banks not offering NOWs in mid-1975 and experiencing significant losses of demand deposits between January 1974 and June 1975, and (3) "low earnings" banks, defined as those banks offering NOWs in mid-1975 with 1974 before tax earnings to total deposit ratios in the lowest 20 percentile in the two states. These 40 banks tend to be relatively small--the median bank having only $17.5 million in deposits--and include only one very large bank.

High Ratio Banks

In June 1975, there were eight "high ratio" CBs--banks with more than 10 per cent of total deposits in NOW accounts. Five of these banks were either established banks with a history of aggressive management prior to the introduction of NOW accounts, or were new banks. In interviews conducted by the Federal Reserve Bank of Boston, it was found that the former group of banks tended to be aggressive in offering NOWs, often introducing them before their competitors and promoting them heavily through advertising. In general, the management of these banks viewed NOW accounts as a means of increasing their market shares by attracting new customers. For these banks, the high proportion of NOWs resulted from a deliberate, aggressive policy by the banks' management.

The remaining three banks tended to be older banks which introduced NOW accounts as a defensive measure. These banks, for one reason or another, found themselves under severe competitive pressures and were forced to introduce NOWs to maintain their deposit base. Two of these banks have an abnormally high ratio of personal demand deposits to total deposits, and thus were particularly vulnerable to competition from thrifts offering NOWs.

Table 6 displays the recent aggregate earnings pattern of six of the eight "high ratio" banks--those six that have been in operation since 1973. The largest of the six banks had negative earnings in the 1972-1973 base period, and positive but low earnings in 1974 and 1975. On balance, the remaining five banks increased their earnings in 1974, but suffered substantial earnings declines in 1975 relative to the 1972-1973 pre-NOW base period.

Of the six banks in Table 6, three indicated that their high concentration of NOWs reflected a deliberate policy of attempting to increase market shares. The remaining three banks were acting defensively. It is difficult to judge for any of these banks the relative importance of NOW costs in the 1975 overall reduction in high ratio bank earnings. However, calculations similar to those of Section III suggest that one large bank experienced an increase in NOW costs exceeding $600,000 in 1975, while two other banks lost at least 10 per cent of 1975 income due to higher NOW costs and outflows of demand deposit funds.

It seems reasonable to surmise that the six high ratio banks--at least in the short run--probably suffered the largest earnings reductions from the NOW experiment. The three banks that acted defensively appear to have had little choice in the matter of whether to offer NOWs; their earnings problems could be severe and could well continue for some time. The remaining three banks were also hard hit by higher NOW costs; however, their aggressive strategies may prove successful in the longer run.

TABLE 6
SUMMARY OF HIGH RATIO BANK EARNINGS

Average Size 1974 Assets (in $ Millions)	Average Ratio of NOWs to Deposits Dec 1975	1972-73 Average After Tax Earnings per Bank (in $ Thousands)	Per Cent Change from 1972-73 After Tax Earnings 1974	1975
40.3	23.7	139	42.0	-28.2

Runoff Banks

In contrast to the "high ratio" banks that had a high ratio of NOWs to total deposits, 16 so-called "runoff" banks lost at least 10 per cent of their demand deposit base between January 1974 and June 1975 and did not offer NOW accounts over this period. Of the 16 runoffs, all but three indicated in interviews that they believed demand deposit outflows were at least partly attributable to NOWs. However, four of the 13 banks that blamed NOWs for demand outflows also indicated that their demand deposit losses due to NOWs were very small.

Most of the 16 runoff banks cited added costs as the reason for not introducing NOWs. Some banks also indicated that they lacked necessary computer facilities required to handle NOW accounts and one bank, which does not pay the ceiling interest rate on savings accounts, expressed concern that offering NOWs would cause added expenses by forcing the savings rate to the ceiling.

Table 7 displays separately the average earnings of those nine banks that felt that NOWs had contributed to demand deposit runoffs and of the seven banks that believed that NOWs had contributed little if anything to runoffs. The earnings records of the two groups of runoff banks in 1975 are quite similar, with both groups of banks experiencing one to two per cent increases in 1972-1973 average earnings. Over the two years, five banks in each category experienced lower earnings relative to 1972-1973 in at least one year, with one bank in the latter category suffering lower earnings in both years.

Again it is difficult to judge how much of the earnings impact of "runoff" banks was due to NOWs. Generally, the earnings of these banks held up better than those of "high ratio" banks that aggressively sought NOWs or defensively acquiesced in offering NOWs. However, the long run earnings potential of runoffs could still be less favorable than that of the high ratio banks.

TABLE 7
RUNOFF BANK EARNINGS

	Average Size 1974 Assets ($ Mils)	Per Cent Reduction in Demand Deposits 12/73-12/75	1972-73 Average After Tax Earnings Per Bank ($000s)	% Change From 1972-73 After Tax Earnings	
				1974	1975
Attributed to NOWs	13.5	22.6	41.2	110.6	1.8
Not Attributed to NOWs	26.2	19.5	351.0	23.5	1.5
Total	19.0	20.9	176.8	34.9	1.5

Low Income Banks

Low income banks are defined as those banks offering NOWs in June 1975 whose ratio of 1974 before tax earnings to total deposits falls in the lowest 20 percentile for the two states. There were 18 banks in this category, with 13 in Massachusetts and five in New Hampshire. These banks all had ratios of before tax earnings to deposits below 0.7 per cent in 1974, a year in which the two-state average for all banks was about 1.2 per cent.

As shown in Table 8, the low earnings banks suffered substantial reductions in earnings in both 1974 and 1975. In 1974, 11 of the 18 low earners experienced a drop in earnings from 1972-1973, while in 1975 the earnings of 14 of these banks were lower than in 1972-1973. However, it cannot be concluded that NOWs were primarily responsible for this sharp decline in earnings for the low earners, because many of these banks, which were selected precisely because their 1974 earnings were low, suffered from relatively large loan losses in 1974 and 1975. Generally low 1975 earnings, moreover, appear to reflect a continuation of 1974 earnings problems as well as increased pressures from NOWs.

TABLE 8
LOW INCOME BANK EARNINGS

Average Size 1974 Assets (in $ Millions)	Average Ratio of NOWs to Deposits Dec 1975	1972-73 Average After Tax Earnings per Bank (in $ Thousands)	Per Cent Change from 1972-73 After Tax Earnings 1974	1975
141.8	2.5	657	-26.7	-103.1
			-46.2*	-62.8*

* excludes earnings record of largest bank in "low income" group

Summary of Marginal Bank Earnings

Table 9 compares the 1974-75 earnings of the 40 Massachusetts and New Hampshire marginal banks to those of the remaining 186 CBs in the two states, to CBs in the four other New England states, and to CBs in the balance of the nation. From this table it is seen that in 1975 even banks in Massachusetts and New Hampshire not included in the marginal bank category generally performed more poorly than other New England banks. Part of this poor earnings performance is attributable to NOWs, since nearly all banks in the two states were affected adversely to varying degrees by NOW pressures in 1975. However, as noted in Section III, NOWs can account for only a small part--an estimated one-fourth--of the drop in after tax earnings in the two states last year. Other factors, including

TABLE 9

Weighted Average Changes in Earnings

Category	Per Cent Change in Earnings from 1972-73: 1974	1975
High Ratio Banks	42.0	-28.2
Run-off Banks	34.9	1.5
Runoff attributed to NOWs	110.6	1.8
Runoff not attributed to NOWs	23.5	1.5
Low Earnings Banks	-26.7	-103.1
Low Earnings Banks - adjusted*	-46.2	-62.8
All Marginal Banks	-11.8	-80.0
All Marginal Banks - adjusted*	-10.3	-37.8
Other Banks		
186 Other CB's in Massachusetts and New Hampshire	9.2	-16.6
CB's in Other 4 New England States	16.7	9.8
CB's in 44 Other States	18.5	19.5

* Excludes earnings record of largest bank in "low income" group

large loan losses resulting from the depressed economies of the two states, presumably account for the remainder of the drop in earnings.

It is clear from Table 9 that the earnings performance of the 40 marginal banks, particularly in 1975, was significantly worse than that of other banks, including the 186 Massachusetts and New Hampshire banks not included in the marginal bank category. However, it would be incorrect to attribute this poor earnings performance totally or even largely to NOWs. According to reports of bank examiners, the major problem for the low income banks has been excessive loan losses and inefficient management. In no case was it concluded in bank examination reports that NOWs were a principal contributor to the earnings problems of low earnings banks. The examiners reports also indicate that NOWs played a relatively minor role in the overall earnings reductions of "high ratio" and "runoff" banks. Indeed, NOWs were mentioned in only a few of the latest examination reports of the 40 marginal banks and in most cases, the examiner's comments were limited to factual observations on NOW growth.

More generally, while earnings were clearly lower for the 40 banks selected for special analysis, it does not appear that NOWs have as yet had a significant adverse effect on the soundness of the Massachusetts and New Hampshire marginal banks. However, NOW-related problems could become severe for some of these banks in the future, particularly those that, for reasons unrelated to NOWs, are presently experiencing earnings difficulties. Reduced revenues from demand deposit outflows or higher costs associated with conversions of demand balances to NOWs could threaten the already weakened condition of these banks. Indeed, although evidence suggests that NOWs per se did not cause the problems of any of these 40 banks, the NOW experiment appears to have, in the short run at least, exacerbated more basic problems faced by several banks. Such banks clearly present the most difficult problem for the banking system in adjusting to financial innovations and regulatory changes.

Portfolio Adjustments by Marginal Banks

CBs with earnings problems can attempt to offset higher NOW costs and lower earnings in two basic ways: by lowering costs by imposing relatively high service charges on NOW accounts, and by raising revenues in any number of ways. As indicated briefly in Section III, there is limited evidence, mostly of a judgmental nature, that CB service charges on NOW accounts are higher on average than those imposed on demand deposits; thus a part, probably small, of increased NOW costs are being recovered through higher service charges.

CBs can attempt to increase revenues by raising loan rates. However, in Massachusetts and New Hampshire, where stiff competition exists from banks in neighboring states and from money market instruments--including commercial paper--such a strategy would likely be counterproductive. CBs can also attempt to raise earnings by including in their portfolios more risky, higher yielding assets. For example, a CB can usually increase revenues by selling short-term, highly liquid assets such as Treasury bills, and using the proceeds to acquire non-prime business or real estate loans. The problem with this strategy is that the acquisition of more loans increases both the level of average earnings and the variation of these earnings. Increased variation in earnings, moreover, generally increases the probability of bank failure. Thus, portfolio adjustments by CBs attempting to maintain a target level of earnings are of considerable importance in examining the stability of commercial banking.

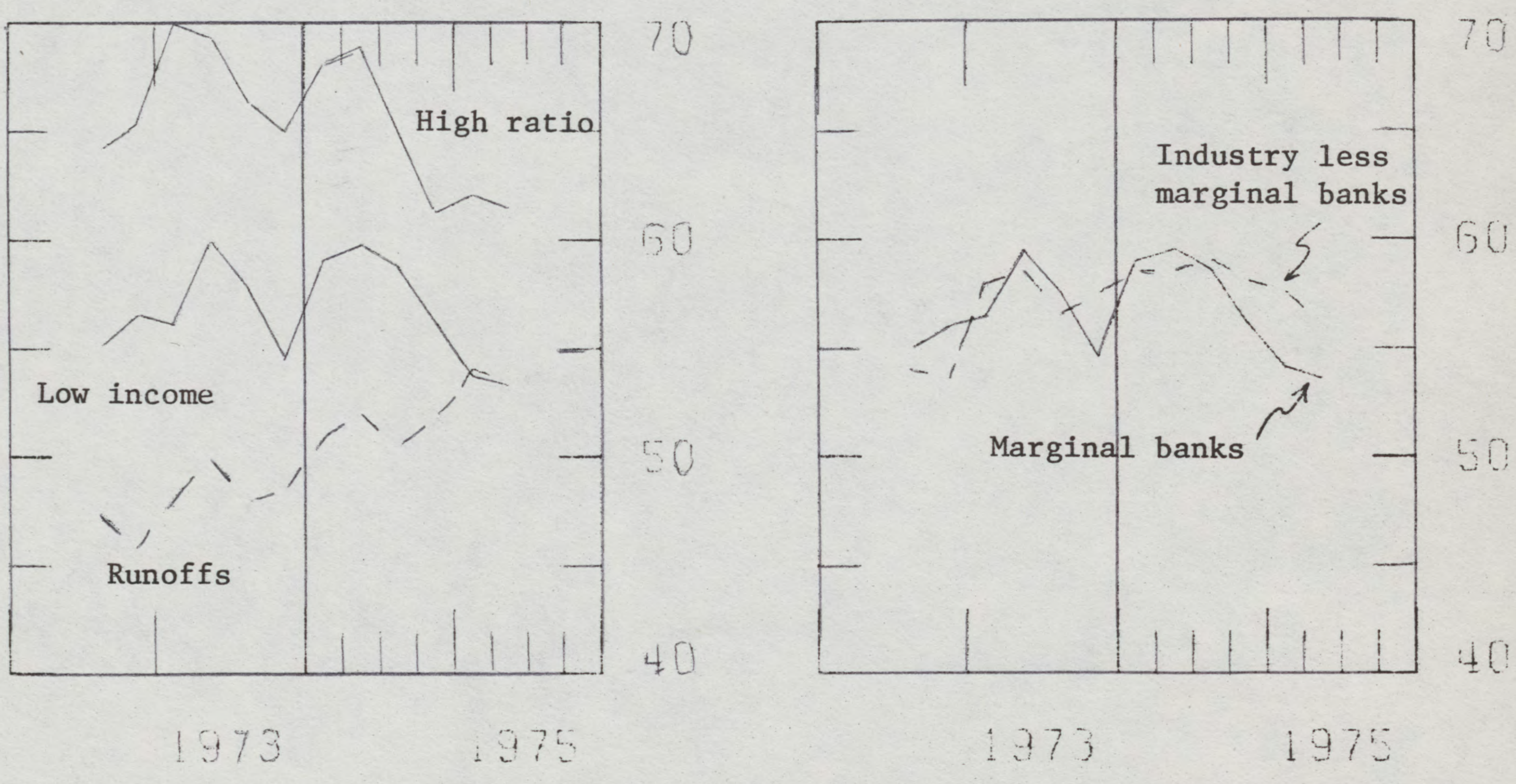
Before reviewing empirical evidence on this matter, it should be noted that, on theoretical grounds, costs and portfolio risk will, under some conditions, be directly related.[11/] Portfolio theory as developed in the last 25 years, however, suggests that rational wealth holders seek to balance benefits of higher rates of return against the disadvantages of additional risk when selecting an optimal portfolio of assets. This behavior, though implying under some conditions that somewhat more risk will be assumed when the return on bank capital declines, is generally incompatible with attempting to maintain a target level of earnings independent of portfolio risk whenever costs or revenues change. This suggests a willingness of bank shareholders to accept somewhat lower earnings in the event of a temporary increase in costs; thus only modest increases in the riskiness of the bank portfolio may result.

11/ See Carl Gambs, "Interest Bearing Demand Deposits and Bank Portfolio Behavior", Southern Economic Journal, July 1975.

The hypothesis that the 40 marginal banks in Massachusetts and New Hampshire have increased portfolio risk in order to offset NOW related lower earnings can be examined by using the ratio of loans to total assets as a very rough measure of risk for each bank. In the left panel of Figure 2, ratios of loans to total assets are shown for each of the three classes of marginal banks. Since early 1974 these ratios have been gradually declining, and this would appear to contradict the "target rate of earnings" hypothesis of CB behavior.

However, the economies of Massachusetts and New Hampshire were depressed during the 1974-75 period, and loan demand was generally weak. Therefore, a comparison of loan ratios of marginal banks relative to

FIGURE 2



all other Massachusetts and New Hampshire banks is shown in the right panel of Figure 2. Because marginal banks experienced greater than average NOW related earnings losses, it might be conjectured that under the target rate of return hypothesis their loan to asset ratios might decline less than that of the industry. Instead, since late 1974 the aggregate marginal bank ratio, as shown in the right panel of Figure 2, has declined more than the industry ratio. Based on this evidence, the 40 marginal banks do not appear to have increased the riskiness of their portfolios, as measured by the ratio of loans to assets, as a result of the NOW experiment.

V. THE LONG-RUN ADJUSTMENT PROBLEM OF COMMERCIAL BANKS

Conversion of time and savings deposits to NOW accounts causes negligible cost increases for CBs. Thus, the problem banks face in the long run is that of absorbing, or offsetting, higher costs associated with conversions from demand deposits to NOWs, and the loss of funds to thrifts. Because CBs have become quite successful in retaining NOW funds, and hence face escalating costs of acquiring funds in the short run, the problem of absorbing such costs will be examined in some detail in the remainder of this section.

Characteristics of the Steady State

The Federal Reserve Board's Demand Deposit Ownership Survey indicates that one-third of all demand deposits are held by households; thus only about \$2 billion of the \$6 billion in demand balances in Massachusetts and New Hampshire could ultimately be converted to NOWs. In Table 2 it was shown that an estimated $670 million of demand deposits had been converted to NOWs as of December 1975. Thus, approximately one-third of all eligible transactions balances were at that time in NOW accounts.

It would be grossly incorrect, however, to attempt to obtain an estimate of the effect of NOWs on CB profits in the steady state--that period after which NOW market shares have stabilized and CBs have made all desired adjustments--by multiplying the December 1975 estimated earnings reductions (Tables 4 and 5) by some number such as 3. Such a calculation would be misleading because it ignores potential adjustments that CBs can make in competing for NOW funds.

Before the payment of interest on NOWs was permitted, CBs competed for transactions balances by offering suppliers of funds various nonpecuniary services, such as free checking, branch banking, longer hours of operation, and larger numbers of tellers to reduce waiting time. At the margin, however, the cost of providing such services generally exceeds the value attached to these services by customers. It is a widely accepted proposition, for example, that whenever the price of a service is set at zero, that service will be consumed by customers until the value to the customer of the last unit is zero. However, there is a positive cost associated with providing, or producing each service unit (e.g., the cost of clearing checks written against a "free" checking account is positive for each check). Thus, the provision of such services is inefficient in the sense that valuable resources are used up in producing services which, on the margin, have relatively low value.

By substituting pecuniary returns--the payment of interest on NOWs--for nonpecuniary services, CBs can eliminate the waste, or inefficiencies, associated with providing nonpecuniary services that have low marginal values relative to cost.[12/] Indeed, by permitting the payment of interest on NOW balances, both customers and banks can be expected to benefit. This can be shown by supposing that banks initially offer free checking services to the public and pay no interest on demand deposit balances. The total return on demand funds derived by customers is thus equal to the value of check cashing services, while the cost to the bank of acquiring demand balances is equal to the cost of servicing their customers' free checking accounts. If banks are allowed to make explicit interest payments to customers with demand funds on deposit, customers will be better off even if they are required to pay for check cashing services as long as the interest rate is set high enough. Moreover, bank costs can be lowered due to reduced costs of servicing checking accounts--which are no longer "free" to customers--if the interest rate is not set too high. Indeed, it can be shown--see Appendix A--that there is a range of interest rates for which both customers and banks are better off--i.e., the total value of bank services to the customer, including interest earned, is higher, while bank costs of providing these services are lower.

12/ For the pre-1933 period, when CBs were permitted to pay interest on demand balances, banks with higher average interest payments tended also to have lower average expenses other than interest. This presumably reflects the substitution of pecuniary for nonpecuniary services by banks offering higher rates of interest on deposits. See George Benston, "Interest Payments on Demand Deposits and Bank Investment Behavior," Journal of Political Economy, October, 1964.

One very important implication of this result--as shown in Appendix A--is that the cost to CBs of acquiring transactions balances can conceivably decline if banks are permitted to pay interest on such balances. This paradoxical result arises from the fact that removing a constraint on the way in which banks can compete for transactions balances allows CBs to select a more efficient (lower cost) strategy for attracting such funds.

Transition to the Steady State

As previously noted, banks began to compete aggressively for NOW funds in 1975. As also noted, continuing competitive pressures may make the transition to the steady state a long, and for many marginal banks, a difficult process. However, after NOW growth begins to moderate and NOW market shares of individual CBs and thrifts stabilize, the aggressive competition for NOW funds should gradually disappear. This will probably occur through a reduction in the level of free nonpecuniary services.13/

To establish that rational pricing of NOW balances will indeed occur at some future date, it is necessary to show that the pricing policy now in effect of offering relatively high rates of return (including both pecuniary and nonpecuniary returns) on a new liability such as a NOW account is neither surprising nor irrational, but represents a short-run strategy consistent with maximizing the sum of current plus discounted future earnings. Indeed, it can be shown--see Appendix B--that when the

13/ Early evidence on service charges on NOWs in Vermont, Rhode Island, Connecticut, and Maine, which began issuing such accounts in March 1976, indicates that depository institutions in those states are pricing NOWs more in accordance with long-run profit maximizing criteria. For example, while in Massachusetts and New Hampshire over half of all issuing institutions offer free NOWs, only about one-quarter of the issuing institutions in the remaining four New England states are similarly offering free NOWs.

future supply of funds arising from a new liability is related positively to market shares established during the transition period before such shares have completely stabilized, a bank seeking to maximize the value of stockholder's equity will temporarily pay higher rates for these funds than is consistent with short-run profit maximization. As market shares begin to stabilize, moreover, the rate of return offered will decline to the profit maximizing level. This implies that current CB behavior in competing aggressively for NOW funds is not inconsistent with stockholder objectives, and more important, as the NOW market "settles down", total rates of return offered on NOW accounts will decline.

The major type of nonpecuniary return offered by CBs which can be easily adjusted is free checking, including free drafts and free account maintenance. In table 10, estimates of NOW costs based on Functional Cost Data from the Federal Reserve Bank of Boston are shown.

Table 10
NOW COSTS FOR A $1000 ACCOUNT

	Item Cost	Number of items per Month	Monthly Cost	Annual Cost
Drafts	$.09	11	.99	11.88
Deposits made	.15	2	.30	3.60
Outside checks Handled	.04	4	.16	1.92
Account Maintenance (Statements, etc.)	2.00	1	2.00	24.00
Total servicing cost per account			3.45	41.40
Interest cost, $1000.00 Account			4.17	40.00
Total cost per account			$7.62	$91.40

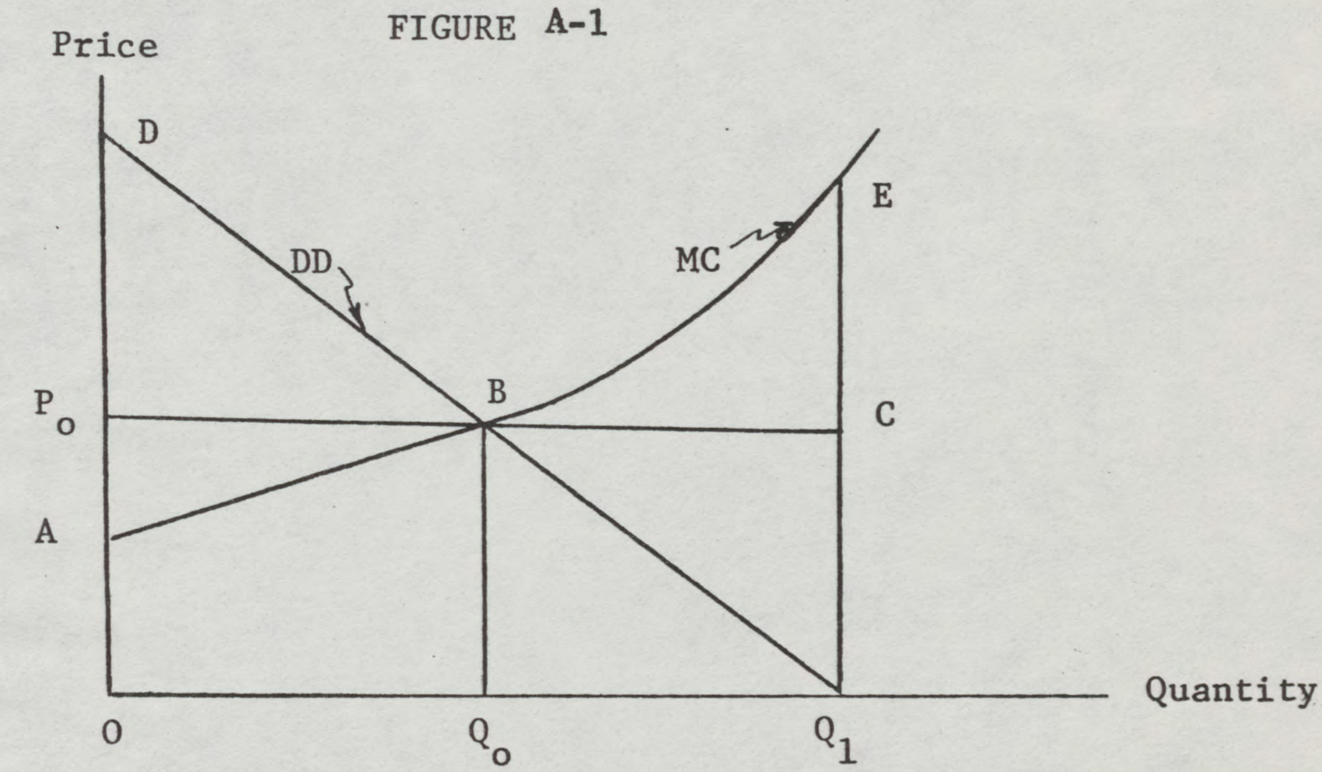
The total annual cost of servicing a NOW account with a $1000 average balance is about $90, of which nearly half ($41.40) is attributable to non-interest related costs. If a 10 cent charge were imposed on drafts, the cost of servicing an average NOW account would decline to about $80. Moreover, if account maintenance charges were introduced, this cost would drop further to about $55. Since the cost of servicing a free checking account averages about $40, CBs offering such accounts would thus experience, as the transition period proceeds, only moderate increases in costs of acquiring transactions balances if customers are required to absorb draft and account maintenance charges.

Other adjustments which take longer to make--such as reducing the number of branches, constructing less elaborate bank buildings, and the like--will be made later as competitive pressures force CBs to adopt more efficient strategies for acquiring deposits. These adjustments, as noted earlier, will lower CB costs and thereby provide a net gain to the economy through more efficient resource utilization.

APPENDIX A
REMOVAL OF INTEREST RATE CONSTRAINTS, BANK COSTS OF ACQUIRING FUNDS, AND PORTFOLIO RISK*

Suppose that banks can initially offer only non pecuniary services--free checking, long hours, impressive buildings, etc.--in order to attract transactions deposits. The demand for these services is given by the curve DD in figure A-1, while the MC curve represents the marginal cost to the bank of providing such services.

FIGURE A-1



If the price of non pecuniary services is set at zero--as it is for all banks that offer free checking--the quantity demanded of such services will be OQ_1. The area under the DD curve--the area of triangle ODQ_1--thus represents the total value of these services to the customer. The cost of providing this level of services, ignoring fixed costs, is equal to the area under the MC curve--the area of $OAEQ_1$.

---

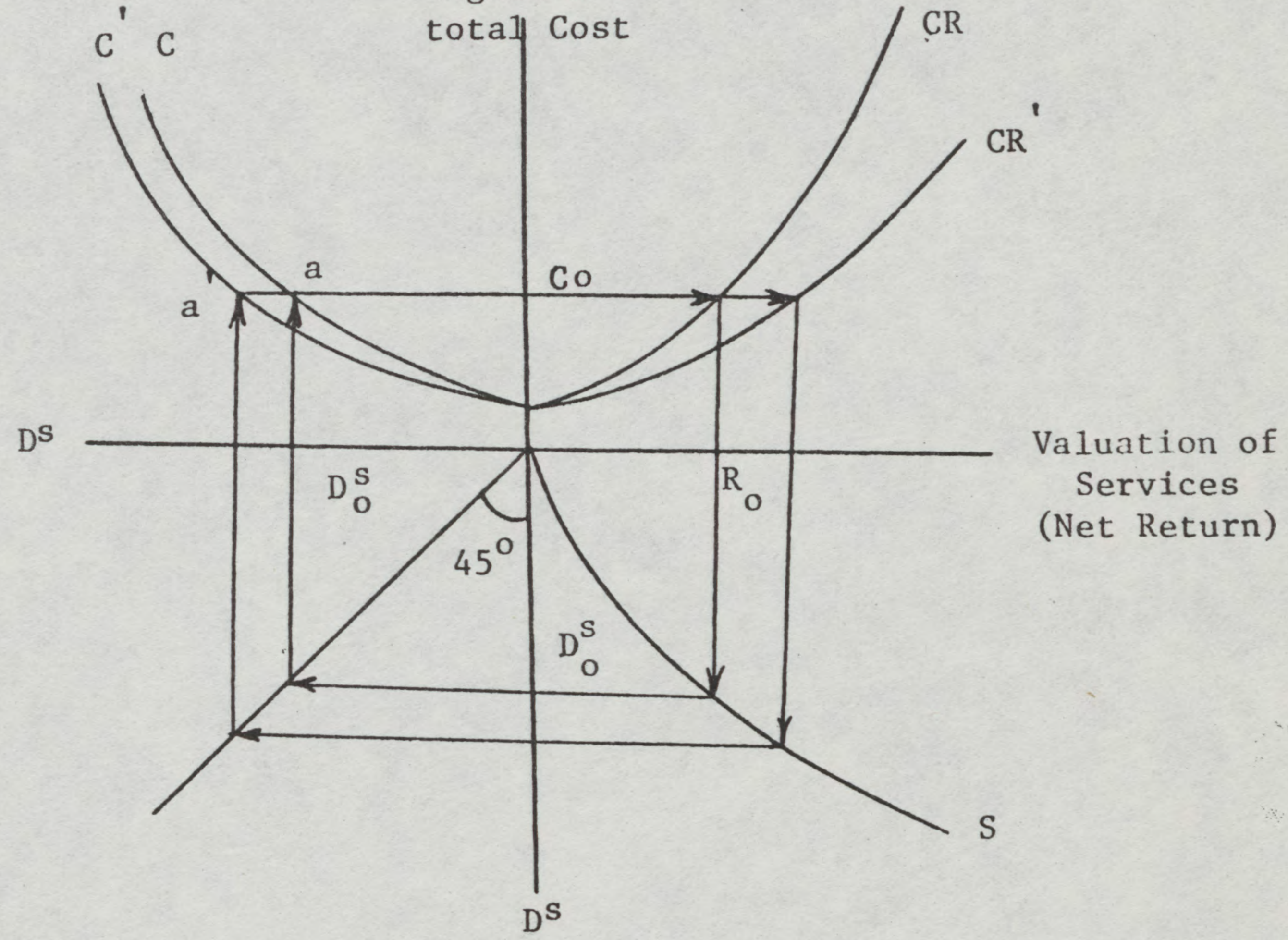
* It is assumed throughout this appendix that bank customers are relatively homogenous and that the number of checks written is positively related to the average balance of each account.

From figure A-1 it is clear that the cost of providing services beyond OQ_o exceeds the value attached to such services by customers. If permitted to pay interest on these funds, banks can eliminate this inefficiency, and still provide customers with the same or greater level of total--pecuniary plus nonpecuniary--services. Moreover, the cost of providing this level of services will be lower.

For example, suppose banks charge customers P_o for nonpecuniary services (e.g., check cashing and statement preparation). The level of such services "purchased" by customers will then drop to OQ_o, which yields a net return to customers equal to the area of the triancle P_oDB (which is equal to the area under the demand curve between 0 and Q_o less the cost paid for services--equal to OP_oBQ_o). Suppose further that the interest rate is set at a level to yield customers a pecuniary return equal to the area of OP_oCQ_1. The total return to customers is then equal to the area under the demand curve between 0 and Q_1 plus the area of the triangle BCQ_1. The area of BCQ_1 thus represents a net gain to customers. The cost to the bank of providing this higher level of services is equal to the area under the marginal cost curve between 0 and Q_o plus the area of the rectangle BCQ_1Q_o. This is less than the area under MC between 0 and Q_1--the original cost of nonpecuniary services--by the area of BEC. Thus, by paying this particular interest rate on funds, total returns to customers are increased, while bank costs have declined. Moreover, any interest payment greater than OP_oBQ_1 but less than OP_oBEQ_1 will similarly raise total returns to customers while lowering bank costs.

This result can be easily extended to show that the cost of funds will decline if banks are permitted to pay interest on deposits. In the northeast quadrant of figure A-2, let the curve CR describe the relationship between bank costs of providing services and the valuation of those services by customers. Next, in the southeast quadrant, let the curve S represent the customers' supply function of deposits. This curve has the usual property that as total returns offered by banks increase, the supply of funds rises.

figure A-2



The cost of acquiring funds is depicted by the curve C in the northwest quadrant of figure A-2. This curve is derived from the CR and S curves by use of the 45 degree translation line in the southwest quadrant. For example, if bank costs are C_o, the level of services offered to customers will be R_o. According to the supply function S, customers will then supply D_o^s in funds. Thus, deposits totaling D_o^s are supplied when bank costs are C_o, as indicated by the point a in the northwest quadrant.

The payment of interest on deposits shifts the CR curve to the right to C R', since, as shown, a higher return to customers can be achieved by a given expenditure of bank funds. It is easily seen from figure A-2 that this shift causes the C curve to shift downward to C'. Thus, by removing the constraint against the payment of interest on transactions balances--and thereby permitting banks to adopt a more efficient strategy for attracting funds--the cost to banks of acquiring funds will decline.

Finally, the lowering of the C curve has implications for the amount of portfolio risk a bank will undertake. It has been shown[1/] in the context of a mean-variance portfolio model[2/] that if bank owners have a quadratic utility function[3/] the amount of portfolio risk a bank will undertake rises whenever the risk-return curve shifts downward, and declines when an upward shift occurs. The lowering of the C curve in the steady state would tend to raise the mean-variance curve. Thus,

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1/ See Carl Gambs, op. cit.

2/ The mean-variance portfolio model was developed by Harry Markowitz, Portfolio Selection, Efficient Diversification of Investments, New York: John Wiley & Sons, 1959 and James Tobin, "Liquidity Preference as Behavior Towards Risk", Review of Economic Studies, February 1958. For a comprehensive review of portfolio theory including recent developments, see Michael Jensen, "Capital Markets: Theory and Evidence", Bell Journal of Economics and Management Science, 1972.

3/ Quadratic, that is, in the mean and variance of the distribution of expected returns.

in the long run, bank portfolio risk might be lowered as a result of the payment of interest on transactions balances. In the short run, the C curve is raised and the mean-variance curve is lowered, thus implying that portfolio risk might increase. However, as noted in Section IV, there is no evidence as yet of such a change in the riskiness of bank assets in Massachusetts and New Hampshire.

APPENDIX B

SHORT-RUN PROFIT MAXIMIZATION AS A SUB-OPTIMAL CRITERION WHEN THE LONG-RUN SUPPLY OF FUNDS DEPENDS ON MARKET SHARES ESTABLISHED DURING A TRANSITION PERIOD

Suppose a new bank liability is introduced and that the long run supply of funds to each bank depends positively on the market share established during a transition period. Suppose further that the bank wishes to maximinize the sum of current plus future discounted profits. For a two-period world the formal problem is:

maximinimize $W = \Pi_t + \frac{1}{\rho} \Pi_s$

where $\Pi_t = (i_t - r_t) D_t$ profits during the transition period

$\Pi_s = (i_s - r_s) D_s$ profits in the steady state

ρ is a discount rate

i_t is the rate earned on investments during the transition period.

r_t is the offering rate on the new liability (including both pecuniary and nonpecuniary services) during the transition period

i_s is the rate earned on investments in the steady state

r_s is the offering rate (also includes both pecuniary and non-pecuniary services) in the steady state ($r_s < i_s$)

The deposit supply functions are of the forms:

$D_t = D_t(r_t)$ $\quad \frac{\partial D_t}{\partial r_t} > 0$ (Supply function during transition)

$D_s = D_s(r_s, D_t)$ $\quad \frac{\partial D_s}{\partial r_s}, \frac{\partial D_s}{\partial D_t} > 0$ (Supply function in steady state)

Note that the supply of funds during the transition period depends positively on the offering rate, while the supply in the steady state, or long run, depends positively on the market share--D_t--established during the transition period in addition to the offering rate.

To maximinize W (wealth), we differentiate with respect to r_t and r_s and set both expressions to zero:

$$\frac{\partial \Pi_t}{\partial r_t} + \frac{1}{\rho} \frac{\partial \Pi_s}{\partial r_t} = 0$$

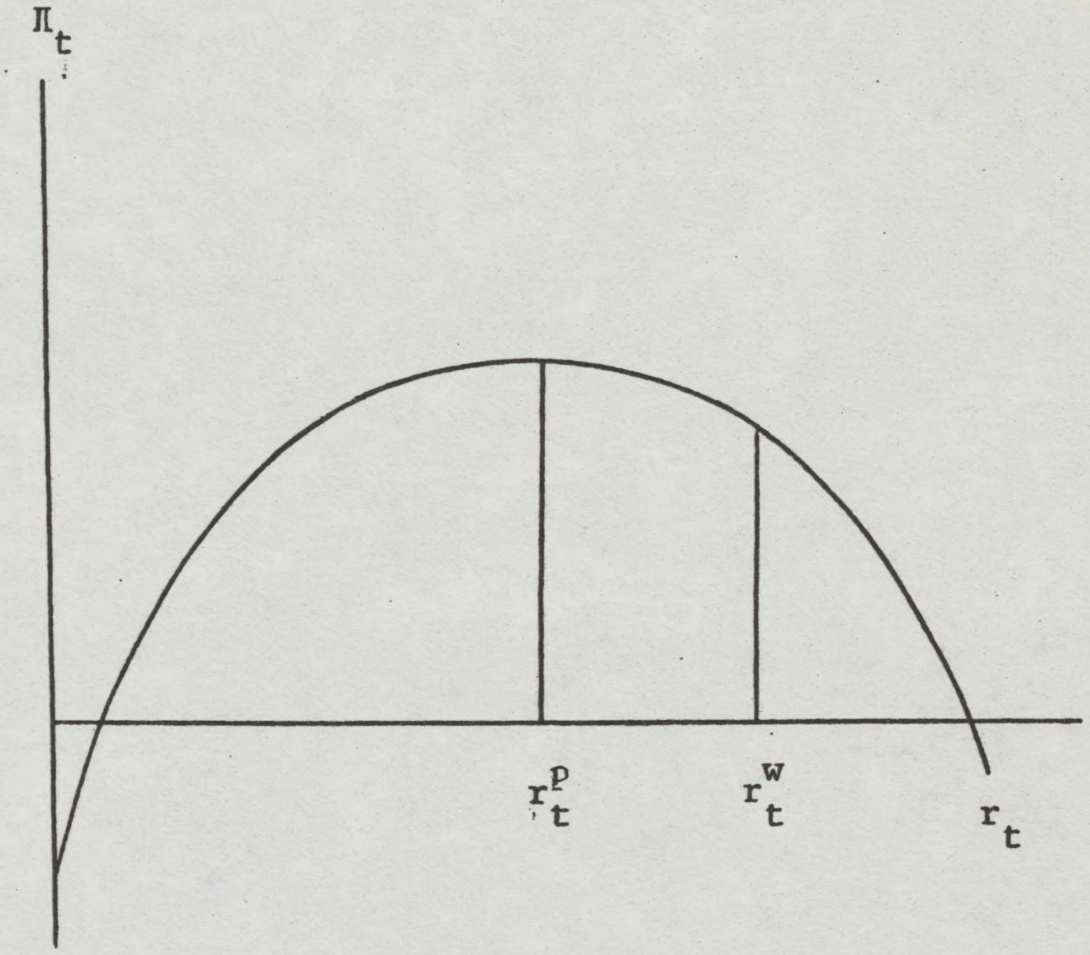
$$\frac{1}{\rho} \frac{\partial \Pi_s}{\partial r_s} = 0$$

Differentiating Π_s with respect to r_t yields

$$\frac{\partial \Pi_s}{\partial r_t} = (i_s - r_s) \frac{\partial D_s}{\partial D_t} \frac{\partial D_t}{\partial r_t} > 0$$

Because $\partial \Pi_s / \partial r_t$ is positive, the partial derivative $\partial \Pi_t / \partial r_t$ must be negative if the first order profit maximinization conditions are to be satisfied (first equation above). This implies that if the first period profit function is concave with respect to r_t, as is usually assumed, then the rate r_t that maximizes wealth is <u>greater</u> than the first period profit maximizing rate. This is shown in figure B-1, where r_t^p and r_t^w are the transition period profit and wealth maximizing prices, respectively. Notice that r_t^w--the rate offered by a bank maximizing wealth (or, equivalently, stockholders equity)--is higher than r_t^p; this follows from $\partial \Pi_t / \partial r_t$ being negative.

Figure B-1



Finally, the condition $\partial\Pi_s/\partial r_s = 0$ implies that in the steady state, after market shares have stabilized, rate setting will be based on traditional profit maximizing considerations.

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

Office Correspondence

Date August 30, 1976

To Chairman Burns

Subject:

From Theodore E. Allison TEA

By letter of April 19, 1976, Congressman Reuss requested copies of any studies or analyses prepared by the staff on NOW account developments. (His letter and your response are attached.) Members of our Research Division subsequently indicated to the House Banking Committee staff that it might be late summer before such a study was available, and the Banking Committee staff was agreeable with that timetable.

I have enclosed for your review a study that has been prepared by Mr. Paulus and reviewed by Governor Partee. Governor Partee's suggestions have been fully incorporated into the final draft, and he had no objection to sending the study to the Congress.

Ken Guenther wants you to know that this study could figure in discussion of the "Williams amendment" (which would extend the NOW account experiment to New York and New Jersey), but that doesn't concern him; Reuss' office calls regularly to inquire about the study, and he thinks it should be sent.

If you concur in the sending of this study, the attached letter to Congressman Reuss may be used to transmit it. Ken's office will make an appropriate distribution among staff of key members of the House and Senate. Governor Gardner will send the study to the other members of the Interagency Coordinating Committee. Also, given the relatively large numbers of requests for copies of studies of NOWs, the staff has suggested that the paper be released to the general public as one of a series of "staff studies."

Attachments

DRAFTED BY: Lyle Gramley
Normand Bernard

REVIEWED BY: Ken Guenther
Gov. Partee OK - JLP

B-154

April 26, 1976

The Honorable Henry S. Reuss
Chairman
Committee on Banking, Currency
and Housing
House of Representatives
Washington, D.C. 20515

Dear Mr. Chairman:

A Board staff study of the NOW account experiment in Massachusetts and New Hampshire has been underway for several months, but it has not yet been completed. I hope the study will be of sufficient interest, and of high enough quality, to merit distribution, but that has not yet been ascertained.

Our own staff work on the NOW account experiment has been independent of the work done at the Federal Reserve Bank of Boston. We have been in touch with the Bank and they will send studies published by their staff directly to your office.

Please let me know if I can be of further assistance.

Sincerely yours,

(signed) Arthur F. Burns

Arthur F. Burns

bcc: Mr. Eisenmenger--Boston Fed
LEG:NB:pjt (#B-154)
bcc: Mr. Gramley
Mrs. Mallardi (2)

FR-7 (Rev. 9/75)

Date. 4/21/76 Control No. B-154

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

CONGRESSIONAL MAIL
PRIORITY HANDLING

To: Mr. Gramley

Please review promptly the attached correspondence from ~~Senator/Congressman~~ Chmn. Reuss and let me have your suggestions in rough draft.

In order to meet the Chairman's requirement for a response within five (5) working days, it will be necessary for me to have your reply by 4-27.

The final letter will be signed by:

(X) Chairman Burns
( ) Governor ______________
( ) Mr. Guenther or Mr. Brenneman

Please indicate below the name and extension of the person who drafts the reply. When reviews are required within your Division, please complete these before forwarding the draft reply to me.

Reply drafted by: __________________ Ext. ________

If there are any problems or questions please give me a call; otherwise, please return this form directly to me with the draft reply and any attachments that are appropriate. Many thanks.

Carol O'Brien
Room B-2214 Ext. 2735

U.S. HOUSE OF REPRESENTATIVES

COMMITTEE ON BANKING, CURRENCY AND HOUSING

NINETY-FOURTH CONGRESS
2129 RAYBURN HOUSE OFFICE BUILDING
WASHINGTON, D.C. 20515

225-4247

April 19, 1976

#154

Honorable Arthur F. Burns
Chairman
Board of Governors
Federal Reserve System
Washington, D.C. 20551

Dear Mr. Chairman:

As you know, P.L. 93-100 which was signed into law on August 16, 1973, provided for the issuance of NOW accounts in the States of Massachusetts and New Hampshire. It is my understanding that the Federal Reserve Bank of Boston, along with the staff of the Board of Governors of the Federal Reserve System, have been engaged in a detailed economic study of the so-called NOW account experiment.

I would appreciate it if you could send us any studies or analyses which the Boston Fed or your staff has completed on the subject, or any studies that might be available in the near future.

Sincerely,

Henry

Henry S. Reuss
Chairman

August 24, 1976

President Volcker -- N.Y.
President Morris -- Boston

Subject: Senate Banking Committee Language Re-NOW Accounts for New York and New Jersey

H.R. 12934 (Federal Reserve Reform Act) and H.R. 3035 (Payment of Interest on Public Demand Deposits) have now been reported. Both bills contain identical language extending a mini-NOW account experiment to New York and New Jersey.

Language of the bill as reported states:

"Section 2(a) of Public Law 93-100 is amended--

(1) by inserting "(1)" immediately after "(a)";

(2) by inserting "New York, New Jersey," immediately after "Vermont,"; and

(3) by adding at the end thereof the following new paragraph:

"(2) Notwithstanding paragraph (1)--

"(A) a federally chartered depository institution (other than a national bank) which is located in New York or New Jersey may allow the owner of a deposit or account to make withdrawals by negotiable or transferable instruments for the purpose of making transfers to third parties if all depository institutions which are chartered by the same

State in which that federally chartered depository institution is located are authorized by or under State law to allow such withdrawals or to provide checking accounts; and

"(B) a federally chartered depository institution which is located in New York or New Jersey may pay interest or dividends on such a deposit or account if all such State-chartered depository institutions are authorized by or under State law to pay interest or dividends on such a deposit or account."

In strongly stated additional views Senators McIntyre and Brooke criticized Committee action as "unnecessary and undesirable." They object to the "attitude that the Federal Government should only go so far as the States, and no farther in granting new powers to financial institutions chartered under Federal Law," note that the Committee action "flies in the face of action taken by the Senate last December" when it passed the FIA, and contend that this action "represents an inexcusable step backward in terms of the public interest."

McIntyre and Brooke indicate that when either bill is considered on the floor that they "intend to support an amendment to incorporate the proposal originally offered in Committee to do the same for New York and New Jersey, with a one year delay in the ability of NOW accounts in New York and New Jersey to pay interest."

They note that in the absence of such an amendment "that the Congress would better refrain from taking any action with respect to New York and New Jersey at the present time."

Copy of bill and report is being airmailed.

K. Guenther

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

June 30, 1976

The Honorable William Proxmire
Chairman
Committee on Banking, Housing and
Urban Affairs
United States Senate
Washington, D. C. 20510

Dear Mr. Chairman:

Thank you for the opportunity to comment on the proposed amendment to legislation extending the moratorium on the authority of States and localities to levy "doing business" taxes on out-of-state financial depositories. The proposed amendment would make many of the provisions of the Financial Institutions Act (S. 1267) applicable to eight Northeastern States.

The Board has not had an opportunity to consider carefully the ramifications of applying a modified FIA to one region of the United States and consequently has no overall position on this proposed amendment at this time. However, the Board believes that careful consideration should be given to certain problems raised by regional application of the FIA.

One such problem results from the authorization, in one area of the country only, for corporations and State and local governments, as well as individuals, to maintain NOW accounts. In the Board's view, this authorization has the potential of inducing substantial flows of deposits into the affected region. For example, even with the proposed geographic restrictions, national corporations with headquarters in one of the Northeastern States, such as New York, would be likely to shift demand balances held outside the region into NOW accounts. Such shifts could have a serious detrimental effect on banks in other areas of the country.

The Board is also uncertain about the implications of including State officials in deliberations of the Federal regulatory agencies on matters relating to interest on deposits. The difficulties raised by such a required procedure could significantly impede the ability of the Federal regulators to deal effectively with financial issues of national significance.

The Board notes that the provision contained in S. 1267 that would remove the current prohibition on the payment of interest on demand deposits has been deleted from the current proposal. The Board regards this change as a prudent step and is prepared to conduct further study on the effects of permitting interest to be paid on demand deposits.

We stand ready to assist the Congress in any way that we can in the course of its consideration of this legislation.

Sincerely yours,

Arthur F. Burns

March 5, 1976

TO: Eisenmenger, Kimball, Basch, Andersen and White (FRB of Boston)

SUBJECT: NOW Accounts

Kichline
Mingo
Boltz
Quick
Lindsey
Salop
Williams
Susskind
Winn
Gunther

FROM: EDWARD C. ETTIN

Attached is a draft of Paulus' paper on NOW accounts. Lyle Gramley has not yet seen it.

Would you please send any comments you may have directly to Paulus no later than March 15. A final version will them be sent to Lyle with a recommendation that it, and the attached covering memo, be sent to the Board.

D R A F T

To: Board of Governors

From: Lyle Gramley   Subject: NOW Accounts

The attached staff memorandum, prepared by Mr. Paulus, analyzes the effect of the NOW experiment on commercial bank market shares, costs, earning, and portfolios. His conclusions are summarized on pages 5-7.

In testimony before the Subcommittee on Financial Institutions, Supervisors, Regulations, and Insurance of the House Banking Committee, Governor Mitchell indicated last fall to Congressman St. Germain that it was time for such a study to be prepared. The Board may wish to transmit Mr. Paulus' paper to the appropriate Congressional Committee as staff views regarding the impact of the NOW experiment on commercial banking in Massachusetts and New Hampshire

DRAFT
February, 1976

EFFECTS OF NOW ACCOUNTS ON COMMERCIAL BANK COSTS AND EARNINGS

by
John D. Paulus*

I. INTRODUCTION

In June 1972 the Massachusetts Supreme Court ruled that state law did not prohibit negotiable orders of withdrawal (NOW) from savings accounts. Following this ruling, several State chartered Mutual Savings Banks (MSBs) in Massachusetts began to issue NOW accounts, and, in September, a savings bank in New Hampshire began offering NOWs after determining that New Hampshire law was similar to that of Massachusetts. Although these rulings allowed state-regulated MSBs to participate in the NOW market, federally chartered or insured depository institutions could not--under Federal regulations--offer NOWS. The resultant controversy led to congressional legislation--public law 93-100--signed into law on August 16, 1973, authorizing all depository institutions (except credit unions) in Massachusetts and New Hampshire to offer interest bearing deposits on which withdrawals by negotiable order could be made. This legislation thus established a formal experiment in the two states in which limited demand deposit powers were extended to thrifts and the payment of interest on transactions balances was authorized for the first time since 1933.

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* Acknowledgments: Ralph Kimball, Edward Ettin, Jeff Suskind, Rebecca Wright, John Williams, Paul Boltz, Perry Quick.

Regulation and Growth

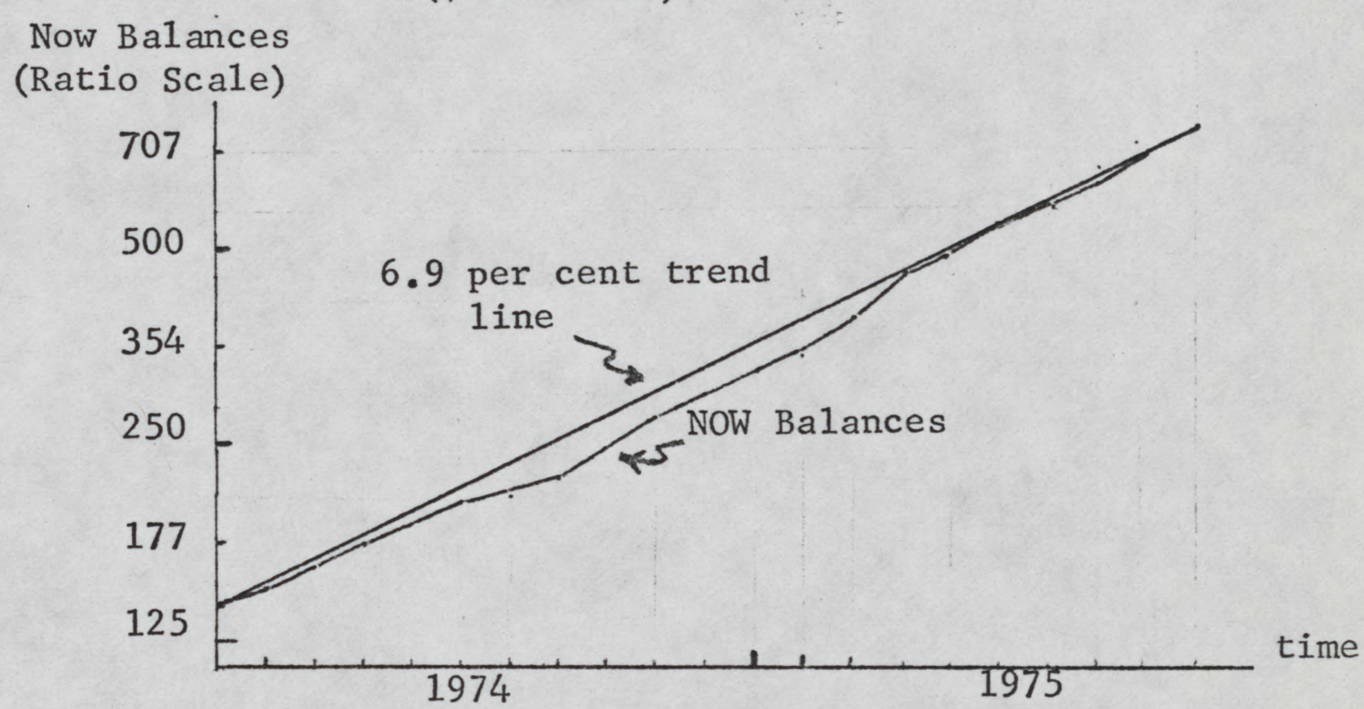
Regulation of NOW accounts was left to the Federal Reserve Board, the Federal Home Loan Bank Board, and the Federal Deposit Insurance Corporation. All institutions were authorized to begin offering NOWs on January 1, 1974, and NOW accounts were to be issued exclusively to individuals, non-profit organizations and sole proprietorships--partnerships, corporations and financial institutions were prohibited from holdings NOWs. Because eligible individuals and institutions held an estimated one-third of the $6 billion in demand deposits in Massachusetts and New Hampshire in 1974, this prohibition limited to about $2 billion the maximum level of conversions from commercial bank (CB) demand balances to NOW accounts.

The three agencies imposed an interest rate ceiling of 5 per cent on NOW accounts, the same as on savings deposits at CBs but one-fourth of a point less than thrifts are permitted to pay on savings deposits. Presently, nearly 98 per cent of all institutions offering NOWs pay this 5 per cent ceiling rate of interest.

Congress did not include in the law uniform reserve requirements against NOWs. Thus, members of the Federal Reserve System treat NOWs as savings deposits for purposes of calculating required reserves. Member banks must therefore hold 3 per cent in required reserves against NOW balances, as compared to reserve requirements averaging 10 per cent on demand deposits. Nonmember banks and thrifts in Massachusetts and New Hampshire essentially hold no reserves in non-interest bearing form against either demand deposits or NOW accounts.

The popularity of NOWs with consumers is evidenced by the rapid and steady growth of these accounts. In the 20 months between January 1974 and September 1975, NOW balances grew at an average rate of about 7 per cent <u>per month</u>, advancing from $143 million to $713 million. As shown in Figure 1, the monthly growth rates over this period have been quite stable, though during August and September, the last two months for which data are available, the rate of NOW growth declined slightly to 6-1/2 per cent per month. However, there is no reason to expect a significant slowing in NOW growth in the next few months.

figure 1
NOW BALANCES
($ Millions)



Purpose and Scope

NOW accounts have evolved into a very close substitute for personal checking accounts, thereby eroding CBs traditional monoply position in the issuance of these accounts. With such erosion, CBs in Massachusetts and New Hampshire have lost the exclusive claim to offering "one-stop banking" to customers who, for convenience, might be willing to maintain a time or savings account, even at relatively unfavorable interest rates, at an institution that provides checking services. Moreover, the payment of interest on NOW accounts, many of which represent direct conversions of zero-interest demand deposits, has raised the average costs to CBs of acquiring funds.

These factors suggest that NOW accounts could affect the stability and the viability of commercial banking in Massachusetts and New Hampshire as CBs attempt to adjust to the new, more competitive environment. This issue--the stability of commercial banking in the two states during the adjustment period--is the subject of the remainder of this memorandum. Both aggregate and micro data are used to study the adjustment of banks in the two states. In Sections II and III, a broad view is taken of industry wide developments in banking in 1974 and 1975. Shifts in market shares are reviewed, and the hypothesis that the spread of one-stop banking to thrifts might cause CBs to lose significant amounts of demand related funds--such as small time and savings deposits--is examined. Rough estimates of the direct effect of NOW accounts on CB's costs and earnings since January 1974 are also developed and discussed.

In Section IV the emphasis shifts to the adjustment problem of selected individual CBs. In any industry, it is the "marginal" firms--those firms with relatively high costs, or inadequate revenues--that determine the capability of the industry to adjust to changes in the competitive and regulatory environment. The effect of NOW accounts on costs and earnings of 39 such banks are therefore analyzed for 1974 and 1975. Moreover, adjustments to asset portfolios are considered to determine whether these banks have attempted to offset lower earnings by undertaking more risky investments.

In Section V, characteristics of the steady state--the period after which the industry has had ample time to adjust fully to NOW accounts--are discussed, including implications for the allocation of resources and the extent to which the public benefits, on balance, from the issuance of NOW accounts. In addition, future CB adjustment problems are considered as NOW balances continue to grow toward some steady state value.

Summary and Conclusions

NOW related flows of funds have had only a modest effect on the CB share of total deposits in Massachusetts and New Hampshire. By September 1975, some 20 months after the NOW experiment began, households in the two states had converted an estimated $330 million in CB demand balances to NOW accounts at thrifts. However, there is no evidence that significant flows of time and savings deposits have accompanied this demand outflow from CBs. Thus, NOW induced shifts in deposit flows, limited mainly to demand deposits, appear to have reduced the CB share of deposits in the two states--which total nearly $40 billion--by about one percentage point.

The effects of NOWs on CB costs and earnings are limited by the relatively small size of the NOW market in the two states. Demand balances eligible for conversion to NOW accounts represent less than 15 per cent of total deposits at CBs. Higher costs and deposit outflows associated with NOWs reduced CB after tax earnings an estimated 2.5 per cent in 1974. In 1975, heightened consumer awareness of NOWs caused an acceleration in the growth of these deposits, resulting in substantial increases in bank costs of funds. For the first nine months of the year, the estimated earnings reduction attributable to NOWs is more than twice that of 1974. An examination of those banks that appear to be most vulnerable to competitive pressures from NOWs revealed that, although a few--perhaps a half dozen--are suffering from significant earnings reductions due to NOWs, most so called marginal banks are not experiencing severe adjustment problems.

Although NOW funds remain relatively expensive, banks and thrifts continue to compete aggressively for such deposits, despite low rates of return on money market instruments and continuing weak demands for business loans. Over the longer term, however, such competition should diminish as NOW growth moderates and market shares stabilize. It seems plausible, moreover, that this stability will produce more rational pricing of NOW funds, including the imposition of higher service changes that should help to relieve cost pressures on CBs.

Finally, it is argued that after all adjustments are complete--a process that might take several years--CB costs of acquiring transactions balances could ultimately decline as a result of removing the restriction against the payment of interest on such funds. By permitting banks to select a more efficient strategy in competing for funds--i.e. by permitting banks to substitute pecuniary for lower valued nonpecuniary services as a means of attracting deposits --it is shown that the allocation of resources in banking will improve.

II. FLOWS OF FUNDS AND MARKET SHARES

The share of the NOW market held by CBs, shown in Table 1, has risen steadily since the beginning of the NOW experiment, reaching 39 per cent last September. MSBs now hold 49 per cent of all NOW balances, while savings and loan associations and cooperative banks (S&Ls and Coops) hold the remaining 11 per cent. During 1974, CBs and MSBs each captured 41 per cent of net new NOW balances, with S&Ls and Coops attracting 18 per cent. In contrast, in the first 9 months of 1975, CBs acquired 53 per cent of the increase in NOWs, while MSBs and S&Ls and Coops received 35 and 12 per cent, respectively, of net new inflows.

The success of CBs in 1975 in attracting, or retaining NOW funds can be attributed in part to the large increase in the number

TABLE 1
OUTSTANDING BALANCES AND SHARES - NEGOTIABLE ORDERS OF WITHDRAWAL (NOWs)
(in thousands of dollars)

MONTH ENDED	TOTAL OF ALL OFFERING INSTITUTIONS	COMMERCIAL BANKS			SHARE OF TOTAL NOWS	MUTUAL SAVINGS BANKS			SHARE OF TOTAL NOWS	SAVINGS & LOAN ASSOCIATIONS			SHARE OF TOTAL NOWS
		TOTAL	MASS.	N.H.		TOTAL	MASS.	N.H.		TOTAL	MASS.	N.H.	
1972--Sept.	11,094					11,094	11,094						
Oct.	22,386					22,386	22,386						
Nov.	34,823					34,823	34,363	460					
Dec.	45,272					45,272	44,522	750					
1973--Jan.	60,726					60,726	59,661	1,065					
Feb.	73,451					73,451	71,975	1,476					
Mar.	86,118					86,118	84,162	1,956					
Apr.	94,606					94,606	92,341	2,265					
May	102,045					102,045	99,633	2,412					
June	108,381					108,381	105,688	2,693					
July	113,418					113,418	110,486	2,932					
Aug.	117,005					117,005	113,852	3,153					
Sept.	120,223					120,223	116,259	3,964					
Oct.	130,361					130,361	125,873	4,488					
Nov.	136,872					132,872	131,795	5,077					
Dec.	143,254					143,254	138,028	5,226					
1974--Jan.	143,190	2,556	2,274	282	.02	139,779	134,832	4,947	.98	855	855	--	.01
Feb.	150,447	4,338	3,857	481	.03	143,764	138,453	5,311	.96	2,345	2,345	--	.02
Mar.	165,157	6,588	5,916	672	.04	154,007	147,845	6,162	.93	4,562	4,325	237	.03
Apr.	174,682	9,689	8,458	1,231	.06	157,412	150,309	7,103	.90	7,581	6,913	668	.04
May	180,637	11,052	9,296	1,756	.06	159,591	151,510	8,081	.98	9,994	8,351	1,143	.05
June	191,229	13,771	11,156	2,615	.07	164,733	155,946	8,787	.86	12,725	11,089	1,636	.07
July	204,646	17,919	14,175	3,744	.09	171,503	161,544	9,959	.84	15,224	13,223	2,001	.07
Aug.	232,386	32,955	28,450	4,505	.14	180,335	169,119	11,216	.78	19,096	16,781	2,315	.08
Sept.	249,033	39,253	33,597	5,656	.16	187,721	175,340	12,381	.75	22,059	19,314	2,745	.09
Oct.	270,813	46,776	40,245	6,531	.17	197,758	184,830	12,928	.73	26,279	23,316	2,968	.10
Nov.	293,305	55,994	48,563	7,431	.19	206,764	192,577	14,187	.71	30,547	26,689	3,858	.10
Dec.	312,576	65,249	56,989	8,260	.21	213,661	200,083	13,578	.68	33,666	29,747	3,919	.11
1975--Jan.	339,982	82,861	73,517	9,344	.24	220,725	206,797	13,928	.65	36,396	32,369	4,027	.11
Feb.	385,190	107,128	96,647	10,481	.28	236,580	221,506	15,074	.61	41,482	37,215	4,267	.11
Mar.	449,638	137,519	124,706	12,813	.31	262,797	246 259	16,538	.58	49,322	43,980	5,342	.11
Apr.	472,864	150.999	136 165	14,834	.32	268,571	250,780	17,791	.57	53,294	47,185	6,109	.11
May	514,018	172,653	155,318	17,335	.34	283 322	263,978	19,344	.55	58,043	51,388	6,655	.11
June	580,331	210,838	185,923	24,195	.36	304,633	283,134	21,499	.53	64,860	57,315	7,545	.11
July	630,402	233,513	201,607	31,906	.37	327,417	303,805	23,612	.52	69,472	61,554	7,918	.11
Aug.	670,790	256,992	217,936	39.056	.38	337,684	213,117	25,567	.50	76,114	67,519	8,595	.11
Sept.	713,419	280,308	235,029	45,279	.39	351,612	324,005	27,607	.49	81,499	72,407	9,092	.11

Prepared by: Statistical Section, Research Department, Federal Reserve Bank of Boston.
* Includes three member commercial banks.
The above adjustments were made to insure the confidentiality of individual institution data.

of offering institutions relative to that of MSBs. In 1975, through September, the number of CBs offering NOW accounts increased from 64 to 123, while the number of offering MSBs rose only from 157 to 173. Though a large number of S&Ls and Coops entered the NOW market in 1975, their ability to attract NOW balances has been limited by their relatively small size.

Source of NOW Funds

Establishing the source of NOW funds--whether demand deposits, time and savings deposits, or other--is of considerable importance in examining NOW related market share developments and, it will be shown in Section III, in estimating the earnings impact of NOWs on CBs. One important type of evidence on this matter concerns the behavior of active NOW accounts and the proportion of NOW funds in active and inactive accounts. Draft activity against active NOW accounts (i.e. those with at least one draft drawn in a given month) has increased gradually during the experiment, and now averages about 10-1/2 drafts per month. Since the average number of checks written against personal checking accounts in New England in 1974 was about 14, this suggests that active NOW accounts are being used primarily as checking accounts.

As a first approximation it thus seems reasonable to assume that funds in active NOW accounts were acquired largely from demand deposit balances. If, as seems plausible, inactive NOW funds originated primarily in other sources--presumably time and savings deposits--

then total active NOW balances can serve as an estimate of the amount of NOW funds that ~~were converted, or~~ diverted, from demand deposits.

Though there are no data on active and inactive balances, estimates can be obtained from data on the number of active and inactive NOW accounts in the two states. In September, 1975, there were 656,000 NOW accounts at banks and thrifts in Massachusetts and New Hampshire, of which 140,000, or 21 per cent were inactive.[1/] If the average balance in these inactive accounts were equal to the average balance in savings accounts in CBs in New England, which is $1100, then inactive balances totaled some $154 million in September, or about 20 per cent of total NOW balances.[2/] This leaves $559 million, or about 80 per cent, in active balances.

Evidence on growth rates of demand and savings deposits in New England supports the credibility of these figures as estimates

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1/ Of course, the 140,000 inactive accounts include some that were active in earlier months; likewise, some of the accounts that were active in September were inactive in one or more previous months. However, it is believed that the number of drafts written against each account is relatively stable from month-to-month, so that membership in the two classes of accounts--active and inactive--is also relatively stable. A necessary (through not sufficient) condition for stabile membership in the two classes is that the percentage of inactive accounts must be relatively stable. This condition is satisfied adequately in the two states where the percentage of inactive accounts has fluctuated narrowly from month-to-month while declining from 26 per cent in mid-1974 to 20 per cent in September 1975.

2/ Passbook savings balances in thrifts average between $2000 at $3000 in Massachusetts and New Hampshire. However, those savings balances that were converted to NOWs can be expected to be much smaller than the average because of the one-fourth percentage point loss in earnings which becomes significant for large accounts. Moreover, many of the larger savings accounts at thrifts are held by businesses and are therefore ineligible for conversion to NOWs. Thus, the $1100 figure is applied to thrifts as well as to CBs.

of the share of NOW funds attracted from demand relative to other types of deposits. Since January 1974, demand deposits have declined relatively more in Massachusetts and New Hampshire than in neighboring New England states, while savings deposits have continued to grow at rates similar to those of Connecticut, Maine, Rhode Island, and Vermont. In fact, after adjustment for cyclical and regional factors, demand deposits in Massachusetts and New Hampshire appear to have been reduced since January 1974, by an amount which is about equal to the growth in NOWs. This suggests that some high proportion of NOWs, perhaps three-fourths or more, has been attracted from demand deposits.[3/]

In Table 2, estimated active and inactive balances are shown for CBs and thrifts in September 1975. As shown in Column 3,

TABLE 2
ESTIMATED ACTIVE AND INACTIVE NOW BALANCES
September, 1975

Massachusetts and New Hampshire ($ in millions)	NOW Balances	Estimated Inactive Balances	Estimated Active Balances
CBs	280.308	48.005	232.303
MSBs	351.612	86.598	265.014
S&Ls and Coops	81.499	19.507	61.992
Total	731.419	154.110	559.309

3/ For details on demand and savings deposits growth in Massachusetts and New Hampshire relative to other New England states, see Appendix A.

thrifts held an estimated $330 million in active NOW balances in September. These funds, serving largely as checking accounts,[4/] appear to have been obtained primarily from CB demand balances. Of the $100 million in inactive accounts at thrifts, an undetermined part was no doubt obtained from CB time and savings deposits, with most of the remainder representing conversions from time and savings at thrifts. This suggests that between $300 and $400 million of NOW balances currently held by thrifts originated in CB deposits.

Market Shares of Total Deposits

The direct effect of NOW accounts on market shares in the two-state area, where deposits at CBs and thrifts total nearly $40 billion, thus amounts to, perhaps, a one percentage point reduction in the 45 per cent share held by CBs. Though this represents a relatively modest reduction in the market share of CB's, the indirect effect of NOWs on such shares must also be considered before any judgment can be reached on whether major shifts are underway.

This indirect effect involves the spread of convenient one stop banking to thrifts. By permitting thrifts to issue what is essentially a demand deposit, CBs could lose large amounts of time and, especially, savings deposits as demand deposit funds are diverted to thrifts. Commercial bankers are particularly worried about this possibility in view of the one-fourth point advantage thrifts can offer on passbook savings.

4/ Draft activity against active NOW accounts at thrifts averages about 9-1/2 in the two states, only slightly below the average at CBs.

The evidence on this issue indicates that no such shift in deposits between institutions has occurred, as yet. In the upper half of Table 3, market shares of passbook savings are shown for the last four call report dates, beginning in December 1973--just before the NOW experiment began. As shown in the table, CBs share of the passbook savings market, in both Massachusetts and New Hampshire, has actually risen during the NOW experiment. In Massachusetts the share of passbooks held by CBs increased for 16.7 to 19.1 per cent between December 1973 and June 1975, while New Hampshire CBs have increase their share of the market from 27.1 to 31.1 per cent during this period. CBs have made significant gains in this market during the last 20 years, and this evidence suggests that NOW accounts have not retarded this progress.

Comparisons of total market shares are of limited value, since CBs, unlike thrifts, obtain a relatively large and variable part of their deposits from large Certificates of Deposit. Data on total deposits are, nevertheless, presented in the bottom half of Table 3. Though the CB share of total deposits declined from 46 to 44 per cent between mid-1974 and mid-1975, this share remains a percentage point above its June 1972 level (recall that NOW accounts have been issued by MSBs in the two states since mid-1972). In New Hampshire, the market share of CBs has remained relatively stable over the last year, as CBs have successfully protected the gains in market shares made in the early seventies.

TABLE 3
MARKET SHARES OF DEPOSITS HELD BY MAJOR
DEPOSITORY INSTITUTIONS IN MASSACHUSETTS AND NEW HAMPSHIRE

	June 1970	June 1972	Dec. 1973	June 1974	Dec. 1974	June 1975
			PASSBOOK SAVINGS EXCLUDING NOWs			
Massachusetts (dollars in millions)			12,906	13,680	12,883	13,695
Percentage held by						
CBs			16.7	16.5	17.7	19.1
MSBs			73.8	74.6	73.3	72.6
S&Ls and coops			9.5	8.9	8.9	8.3
New Hampshire (dollars in (millions)			1,781	1,824	1,806	1,930
Percentage held by						
CBs			27.1	79.2	29.5	30.1
MSBs			57.1	55.6	55.3	54.8
S&Ls and coops			15.2	15.1	15.2	15.1
			TOTAL DEPOSITS			
Massachusetts (dollars in millions)	21,952	26,956	31,563		32,426	
Percentage held by						
CBs	43.6	43.0	46.0		44.0	
MSBs	49.8	50.3	47.6		49.2	
S&Ls and coops	6.0	6.7	6.4		6.8	
New Hampshire (dollars in millions)	2,234	2,840	3,425		3,693	
Percentage held by						
CBs	36.7	41.4	42.8		42.3	
MSBs	50.1	44.7	43.1		43.1	
S&Ls and coops	13.2	13.9	14.1		14.6	

On the basis of this evidence it appears that, to date, no significant shifts have occurred in market shares beyond those arising directly from transfers of CB deposits into active NOW accounts at thrifts. However, the possibility of such a shift, occurring on a delayed basis, cannot be totally ruled out, particularly if consumers adjust slowly to changing conditions in financial markets.

III. EFFECTS OF NOW ACCOUNTS ON AGGREGATE COMMERCIAL BANK COSTS AND EARNINGS: 1974-1975

In attempting to establish a permanent share of the NOW market, CBs in Massachusetts and New Hampshire have absorbed higher costs through the conversion of demand deposits to NOW accounts and have thus experienced a reduction in net earnings. Moreover, CB net earnings have been further reduced by the loss of relatively profitable demand deposit funds to thrifts offering NOWs. Estimates of the effect of NOWs on aggregate CB earnings must therefore include both the cost of converting noninterest bearing demand deposits to NOWs and earnings reductions associated with NOW related outflows of demand deposits.

In the remainder of this section rough estimates are produced which, it should be emphasized, are indicative only of basic magnitudes. For reasons to be discussed later, these estimates are probably biased in the sense that the true depressing effect of NOWs on CB earnings is more likely to be smaller than these estimates, rather than larger.

Incremental Costs of NOWs

In estimating the added costs to CBs of acquiring and retaining NOW funds, costs of converting time and savings deposits to NOWs are ignored, since such costs are likely to be small. Thus, incremental costs are calculated by multiplying estimated NOW balances at CBs which were converted from demand deposits by the difference between the average cost of NOW funds and that of demand deposit funds. For this purpose, active NOW balances at CBs, as calculated in Section II, will be used to estimate the level of conversions from demand deposits to NOWs.5/

For nonmember banks the average cost of NOW funds is equal approximately to the sum of the interest payment, which averages

5/ In equating conversions of demand deposits to estimated active NOW balances, the consolidation of savings and demand deposit accounts into one active NOW account creates a minor problem, since treating the balance in the active NOW account as originating in a demand deposit causes an upward bias in the estimated level of demand deposit conversions. Because NOW balances at CBs are significantly higher than at thrifts--$1600 at CBs to $900 at thrifts--it might appear that the effect of account consolidation on average NOW balances at CBs is large. However, this is somewhat misleading, since NOW accounts at CBs include conversion of so called D/B/A--"doing business as"--demand deposit accounts of sole proprietorships. These accounts typically carry very large balances ranging up to $50,000 and more. According to knowledgable observers, most of these D/B/A accounts have been converted to NOWs, thereby raising NOW average balances relative to those of demand deposits. For a few CBs whose D/B/A accounts were examined, average NOW balances after excluding D/B/A accounts were much smaller and more consistent with average demand deposit balances. Thus, the effect on average balances of consolidating savings and demand deposit accounts into one active NOW account may be quite small, and active NOW balances, as calculated in Section II, probably serve as a reasonably accurate, though slightly biased estimate of demand deposit conversions.

nearly 5 per cent, and the net cost of servicing NOW accounts. This latter cost consists mainly of expenditures on account maintenance (statement preparation, etc.) and costs associated, to a lesser extent, with clearing drafts and handling deposits to NOW accounts. For Federal Reserve members, the NOW cost is equal to this sum, less the earnings from funds released by the lower required reserve ratio on NOWs relative to demand deposits.

The per dollar marginal cost of demand deposit funds is approximately equal to the net cost of servicing demand deposit accounts. This cost is similar to that of NOW accounts, though probably slightly smaller because a higher proportion of CBs offer free checking than offer free NOWs. If this service cost differential is ignored because of its relative smallness, the incremental cost of NOW funds converted from demand deposits is equal to the rate of interest on NOWs minus, where applicable, the additional earnings from lower reserve requirements against NOWs.

In calculating incremental costs, the interest rate on NOWs is set at 5 per cent and the Treasury bill rate is used to measure earnings from lower reserve requirements for member banks. These estimated costs are presented in Table 4 on a monthly basis beginning in January 1974.[6/] For 1974, the estimated incremental cost of NOWs totaled ~~$880 thousand~~. For the first 9 months of 1975, this total is $5.2 million, reflecting the large growth in NOW balances at CBs this past year. In 1974, before tax CB earnings in Massachusetts and New Hampshire totaled $_____ million; thus estimated incremental costs were about equal to ____ per cent of 1974 earnings, while 1975 incremental costs for the first 9 months of the year are estimated to be about ____ per cent of such earnings. As noted earlier, however, there are several reasons why these estimates probably overstate actual incremental costs. First, the small savings on service changes of NOWs relative to demand deposits are ignored and, second, active balances are used to estimate demand deposit conversions and this estimate is biased upward. Also, the consolidation of savings and demand deposit accounts into a single NOW account reduces CB's costs, since the maintenance cost on a NOW account is smaller than the sum of the costs of maintaining separate demand deposit accounts.

6/ Symbolically, the per dollar NOW cost for a Federal Reserve bank can be expressed as:

$$c_n = i_n + s_n - .07\ r$$

where i_n is the interest rate paid on NOWs, s_n is the annual cost per dollar of servicing a NOW account, r is rate of interest on some asset into which the funds derived from the lower NOW reserve requirement will be invested, and the constant .07 is the difference between the average reserve requirement against demand deposits and NOW accounts. If s_n is ignored on the grounds that NOW service costs are similar to those of demand deposits, the incremental cost of NOW funds is equal to i_n - .07 r for Federal Reserve members, and to i_n for nonmembers. These expressions are used in calculating estimated costs in Table 4.

TABLE 4
ESTIMATED INCREMENTAL COSTS TO CBs OF NOW ACCOUNTS
(in thousands $)

	MEMBER BANKS			NONMEMBER BANKS			
	Active Balances	Monthly Incremental Cost Per Dollar	Incremental Cost	Active Balances	Monthly Incremental Cost Per Dollar	Incremental Cost	TOTAL CB Incremental Cost
1974: Jan.	1,159.0	.00371	4.3	575.5	.00417	2.3	6.7
Feb.		.00375	6.1	1,271.0	.00417	5.3	11.4
Mar.		.00370	9.0	2,278.2		9.5	18.4
Apr.		.00369	12.5	3,765.0		15.7	28.2
May		.00367	13.8	4,076.7		17.0	30.9
June		.00360	17.8	5,155.9		21.5	39.3
July		.00371	27.0	6,546.8		27.3	54.3
Aug.		.00366	47.4	7,506.6		31.3	78.7
Sept.		.00368	51.0	14,220.6		59.3	110.3
Oct.		.00374	59.2	14,508.4		60.5	119.7
Nov.		.00372	74.8	31,390.9		130.9	205.6
Dec.		.00375	92.6	20,479.6		85.4	178.0
							881.5
1975: Jan.		.00379	134.0	25,083.9	.00417	104.6	238.5
Feb.		.00384	190.3	31,366.9	.00417	130.8	321.0
Mar.		.00384	255.9	41.822.5		174.4	430.3
Apr.		.00383	283.2	47,649.9		198.7	481.9
May		.00386	324.6	55,947.2		233.3	557.9
June		.00386	407.6	66,235.0		276.2	683.8
July		.00381	455.5	74,364.5		310.1	765.6
Aug.		.00379	489.9	82,278.2		343.1	832.0
Sept.		.00379	533.8	91,438.8		381.3	915.1
							5,226.1

Reductions in Earnings from Demand Deposit Outflows

The second way in which NOW accounts can reduce CB earnings is through the loss to thrifts of funds which would otherwise have provided positive net earnings for CBs. As noted earlier, the major identifiable loss of CB funds amounts to about $330 million in demand deposit balances through September, 1975.

In attempting to estimate earnings reductions at CBs attributable to NOW induced outflows of funds, active NOW balances at thrifts are used to approximate demand deposit outflows. Savings deposit outflows, which are essentially unknown, are ignored because the earnings from such funds would have been small, especially in 1975 when market interest rates were low, relative to those of demand deposits.

For nonmember banks, per dollar earnings on demand deposits are equal to the average yield on invested funds minus the net cost of acquiring such funds (in the case of demand deposits, the cost of servicing an average account). For Federal Reserve member banks, net earnings on demand deposit funds are equal to this amount multiplied by 9, the proportion, on average, of each demand deposit dollar that can be invested after reserve requirements are met. Studies by Donald Hester and James Pierce indicate that a high proportion of demand deposit funds are invested in short term market securities; thus the Treasury bill rate was used to measure the yield

TABLE 5
ESTIMATED LOST EARNINGS FROM DEMAND DEPOSIT OUTFLOWS
($ thousands)

	MEMBER BANKS			NONMEMBER BANKS			CB EARNINGS
	Cumulative Estimated Outflows	Monthly Earnings Per Dollar	Lost Earnings	Cumulative Estimated Outflows	Monthly Earnings Per Dollar	Lost Earnings	Reduction from Outflows
1974: Jan.	94,831.5	.00356	337.6	17,121.2	.00396	67.8	405.4
Feb.	95,953.4	.00304	291.7	17,337.3	.00338	58.6	350.3
Mar.	103,663.1	.00374	387.7	18,750.0	.00416	78.0	465.7
Apr.	106,607.1	.00392	417.9	19,311.9	.00436	84.2	502.1
May	108.725.5	.00408	443.6	19,735.1	.00453	89.4	533.0
June	111,631.7	.00429	478.9	20,272.5	.00477	96.7	575.6
July	117,752.8	.00356	419.2	21,439.4	.00396	84.9	504.1
Aug.	122,573.1	.00431	532.6	22,526.1	.00479	107.9	640.5
Sept.	128,408.0	.00402	516.2	23,445.2	.00447	104.8	621.0
Oct.	136,175.5	.00319	434.4	24,858.8	.00354	88.0	552.4
Nov.	144,505.8	.00344	497.1	26,361.3	.00382	100.7	597.8
Dec.	154,568.7	.00313	483.8	27,844.8	.00348	96.9	580.7
							6,298.6
1975: Jan.	155,610.7	.00262	407.7	28,384.9	.00291	82.6	490.3
Feb.	170,412.4	.00194	330.6	31,064.8	.00216	67.1	397.7
Mar.	195,418.7	.00203	396.7	35,663.7	.00226	80.6	477.3
Apr.	206,157.6	.00203	418.5	37,654.9	.00226	85.1	503.6
May	219,712.6	.00174	382.3	40,103.6	.00193	77.4	459.7
June	236,242.4	.00165	389.8	43,169.4	.00183	79.0	468.8
July	252,310.9	.00238	600.5	46,098.5	.00264	121.7	722.2
Aug.	257,961.5	.00260	670.7	47,231.8	.00289	136.5	807.2
Sept.	276,378.0	.00254	702.0	50,638.3	.00282	142.8	844.8
							5,171.6

NOTE: Outflows from member and nonmember CBs are assumed to be proportional to market shares of demand deposits of these banks. For example, if member CBs held 80 per cent of demand deposits in a given month, than 80 per cent of active balances at thrifts are assumed to have come from member banks and the remaining 20 per cent from nonmembers.

on demand deposit funds lost to thrifts.[7/] The average cost of servicing a demand deposit account was set at 3 per cent of the average balance. This estimate is based on functional cost data from the Federal Reserve Bank of Boston. These data indicate the cost of servicing a checking account in New England averages between 3 and 4 per cent; since a substantial portion of CBs in Massachusetts and New Hampshire offer free checking, 3 per cent was chosen as the average net cost of servicing such deposits.

Estimates of the earnings reduction attributable to NOW induced demand deposit outflows are presented in Table 5. For any given month, the estimated total outflow is shown for both member and nonmember banks. These outflows include all funds lost in previous months as well as those lost in the current month. For both member and nonmember banks estimated outflows are multiplied by monthly per dollar earnings on demand deposit funds to obtain an estimate of earnings lost each month. For 1974, these estimated earnings reductions total $6.2 million, which is much larger than the 1974 estimate of incremental costs from Table 4. This, of course, reflects the fact that thrifts--especially MSBs--held a large percentage of active NOWs in 1974. The 1975 estimated earnings reduction from demand deposit outflows, which covers only the first 9 months of this year,

7/ See Hester, Donald and James L. Pierce, Bank Management and Portfolio Behavior, Yale University Press, 1975.

totaled $5.4 million.[8/]

After Tax Reduction in Earnings

Adding the estimates of incremental costs of shifts from demand deposits to NOWs at CBs and reduced earnings from demand deposit outflows from CBs to thrifts yields a rough estimate of the total before tax reduction in earnings attributable to NOW accounts. For 1974 this total is $7.2 million, while for the first nine months of 1975, the total is $10.4 million.

To obtain an after tax reduction in earnings it is necessary to reduce these figures by the amount of the tax saving accruing from lower CB earnings. In 1974 more than 90 per cent of Massachusetts and New Hampshire CBs had before tax earnings exceeding $25,000. The marginal tax rate for these banks were therefore 48 per cent, while for the remaining banks the marginal rate was 25 per cent. The weighted average of these marginal rates, with weights equal to the proportion of banks in each class, is thus equal to about 46 per cent. Reducing the estimated $6.8 million 1974 earnings reduction by this amount produces an after tax reduction in earnings of $3.7 million. Since after tax profits in Massachusetts and New Hamsphire totaled $142 million in 1974, this represents a reduction in total after tax earnings of about 2-1/2 per cent.

8/ Concerning the robustness of these estimates to changes in the assumed average balance in inactive accounts, if instead of $1100 this average was twice as large--$2200--the earnings reduction from demand deposit outflows would have been about 30 per cent smaller. For example, assuming a $2200 average balance in inactive accounts at thrifts reduces estimated active balances from $330 million to $230 million in September, 1975. Thus, earnings reductions from demand deposit outflows would be only 23/33, or about 70 per cent, of those shown in Table 5 for that month.

Since no income figures are yet available for 1975, a similar calculation cannot be made for that year. However, if the 1974 tax reduction is applied to the $10.4 million in reduced 1975 earnings, the after tax reduction in earnings attributable to NOWs for the first 9 months of the year is $5.6 million.

IV. ADJUSTMENT PROBLEMS OF INDIVIDUAL BANKS

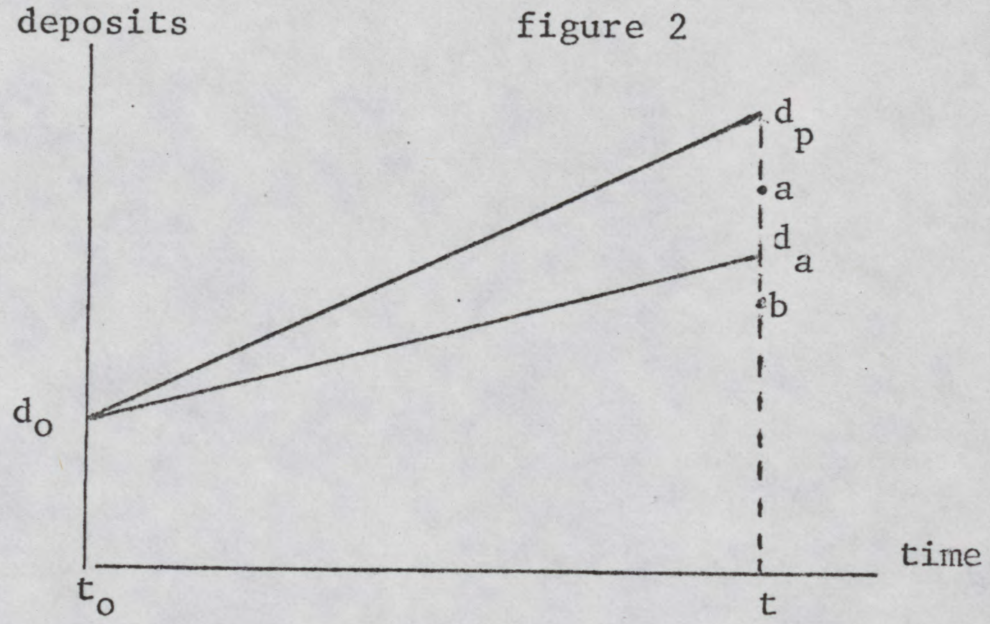
Analysis of aggregative--industry wide--data suggests that, at worst, aggregate CB earnings may have been depressed by a few percentage points in 1974 and 1975. These data, therefore, do not indicate that the industry is experiencing particularly serious adjustment problems. However, aggregative data can often conceal important information. In particular, when an industry is adjusting to a change in basic costs or revenues, certain segments of the industry--those so called marginal firms--may suffer disproportionately high losses of earnings and capital. The adjustment experience of these firms can often reveal far more about the stability of the industry than aggregative data.

The remainder of this section is therefore devoted to a study of costs, earnings, and portfolio adjustments of several such banks in Massachusetts and New Hampshire. Each of these banks belongs to one of the following categories; (1) "high impact" banks having 10 per cent or more of total deposits in NOW accounts in June 1975, (2) banks having low earnings in 1974, or (3) banks not offering NOWs, but experiencing significant losses of demand deposits between

January 1974 and June 1975. ~~Thirty-nine of~~ the ____ banks in the two states fall into one or more of these categories. Obviously, the earnings and capital positions of these banks are especially vulnerable to NOW related changes in costs and revenues.

To estimate the cost and earnings impact of NOWs it is first necessary to project for each bank a level of demand deposits that would have been observed in the absence of NOWs. After this projection is made, actual demand deposits are compared to projected balances. Then, if the actual demand deposit balances of a bank offering NOWs exceed projected deposits, the earnings reductions for that bank from the advent of NOWs is zero, since all NOW balances are, in effect, net new funds. However, for a CB offering NOWs and having actual demand deposits below the projected level, the cost of converting demand balances to NOWs and, possibly, the earnings reduction from an outflow of demand funds both will reduce total earnings. For banks not offering NOWs but experiencing large run-offs of demand balances (category 3), the earnings reduction attributable to NOWs is calculated as the lost earnings from NOW induced outflows of funds as measured by the difference between projected and actual demand deposits.

To illustrate, assume in the absence of NOWs demand deposits are projected to grow from d_o to d_p in Figure 2, and suppose deposits actually grow to d_a. If NOW balances at this bank figure 2



are equal to the distance d_p - b at time t, then NOW conversions from demand deposits are assumed to total $d_p - d_a$, which is, of course, the amount by which projected deposits exceed actual demand deposits. The remaining NOWs--d_a - b--are thus assumed to have been attracted from other institutions. Alternatively, suppose the level of NOW accounts is equal to d_p - a. This amount is then assumed to represent inhouse conversions from demand deposits. However, in this case, NOW balances are less than the "deficiency" in demand deposits as measured by $d_p - d_a$. The difference, a - d_a, is assumed to represent demand balances lost to another institution offering NOWs, and the earnings reduction from this outflow is added to the direct cost of converting demand deposits to NOWs.

Actual projections of demand deposits were based on a comparison of demand deposit growth for each bank relative to the average growth in demand deposits in Maine, Connecticut, Vermont, and Rhode Island during 1972 and 1973. This established a differential between the demand deposit growth rate of each bank and the average growth rate of demand deposits in these four New England states not affected by NOWs. During 1974 and 1975 projected demand deposit growth for each bank was set equal to the average growth in these deposits in the four New England states plus the 1972-73 differential. This method of projection thus assumes that demand deposits of those banks that were growing more rapidly than the average rate in the four New England states in 1972-73 would continue to do so in the absence of NOWs, while those banks whose demand deposit growth was below that of the average would continue to experience slower growth.

As in Section III, the per dollar cost of converted demand deposits is assumed to equal the interest payment on NOWs less, where applicable, the increased earnings from released reserves. The per dollar earnings reduction from lost funds is also calculated as the difference between the Treasury bill rate and the average cost of servicing demand deposits -- which is assumed, again, to be 3 per cent.

High Impact Banks[9/]

In June 1975, there were 8 CBs with more than 10 per cent of total deposits in NOW accounts. Five of these banks were either established banks with a history of aggressive management prior to the introduction of NOW accounts or new banks. In interviews conducted by the Federal Reserve Bank of Boston, it was found

9/ See Ralph C. Kimball,"
Federal Reserve Bank of Boston, for a similar analysis of high impact, low income, and run-off banks.

that the former group of banks tended to be aggressive in offering NOWs, often introducing them before their competitors and promoting them heavily through advertising. In general the management of these banks viewed NOW accounts as a means of increasing their market shares by attracting new customers. For these banks, the high proportion of NOWs resulted from a deliberate aggressive policy by the banks' management.

The remaining three banks tended to be older banks which introduced NOW accounts as a defensive measure. These banks, for one reason or another, found themselves under severe competitive pressures and were forced to introduce NOWs to maintain their deposit base. Two of these banks have an abnormally high ratio of personal demand deposits to total deposits, and thus were particularly vulnerable to competition from thrifts offering NOWs.

Individual bank names and data are not reported in this study. Instead, the number of banks whose before tax income was reduced by various percentages is given in Table 6. Of the eight high impact banks, only five have been in operation long enough to permit a projection of the level of demand deposits which is required to make the cost and earnings reduction calculations. Of these five banks, it is estimated that four had their earnings reduced by less than 10 per cent in 1974, while one had a percentage reduction of about 50 per cent.

In 1975, two of the banks are expected to continue to experience income reductions of less than 10 per cent, two are projected to suffer 10 to 20 per cent reductions, while NOW related changes in costs and revenues are expected to produce negative net earnings in 1975 for one bank. However, it should be noted that this bank is one of the five "high impact" banks whose management was classified as very aggressive. This bank has experienced impressive growth over the past decade and does not appear to be endangered by the added costs from NOW accounts.

Low Income Banks

Low income banks are defined as those banks offering NOWs whose ratio of 1974 before tax earnings to total deposits falls in the lowest 10 per cent for the two states. There are 18 banks in this category, with 13 being Massachusetts CBs and five operating in New Hampshire. These banks all had earnings to deposit ratios below ____ per cent in 1974, while the two-state average for all banks was about ____ per cent.

As shown in the "low earnings" columns of Table 6, about one-half of these banks had 1974 earnings reduced by less than 20 per cent. One bank had negative earnings in 1974 on account of NOW related costs; however, this bank would have had very low earnings--less than $5 thousand--even without added NOW costs which were estimated at about $10 thousand.

In 1975, about half of the low income banks are expected to experience earnings reductions from NOWs of less than 10 per cent,

TABLE 6
EARNINGS REDUCTIONS FROM NOW ACCOUNTS: MARGINAL BANKS

Income Reduced by (per cent)	High Impacts 1974	High Impacts 1975	Low Earnings 1974	Low Earnings 1975	Runoffs 1974	Runoffs 1975	Total 1974	Total 1975
0-10	4	2	5	9	7	7	16	18
10-20	0	2	4	3	4	4	8	9
20-30			3	2	1	0	4	2
30-40			1	0	1	1	2	1
40-50			1	2	3	1	4	3
50-60	1		1	2			2	2
60-70			1	0		1	1	1
70-80			1	0		1	1	1
80-90			0	0			0	
90-100			0	0			0	
100		1	1			1	1	2
Total	5	5	18	18	16	16	39	39

NOTE: One bank belonged to both the "high impact" and the "low earnings" group. This bank is included only in the high impact category in the Table.

while four banks are projected to lose about one-half of their 1975 earnings.

Since many of the low income banks are probably experiencing temporarily low earnings, these banks can be expected to show significantly improved earnings in the next few years even after NOW related costs are fully absorbed. Thus, even the distribution of earnings reductions shown in Table 6, which do not appear to indicate widespread and serious adjustment problems among these banks, probably overstates the impact of NOWs on basic--or permanent--earnings for such banks.

Runoff Banks

Runoff banks are defined as those banks not offering NOWs that lost 10 per cent or more of their demand deposit base between January 1974 and June 1975. Of the 16 runoff banks, only about one half believe that demand deposit outflows are at least partly caused by competitors offering NOW accounts. Most of these banks cited added expenses as the reason for not introducing NOWs. Some banks also indicated that they lacked necessary computer facilities required to handle NOW accounts and one bank, which does not pay the ceiling interest rate on savings accounts, expressed concern that offering NOWs would cause added expenses by forcing the savings rate to the ceiling.

Although about half the runoff banks do not believe that competition for NOW accounts is responsible for their demand deposit outflows, earnings reduction estimates are shown for all 16 banks in Table 6.

Runoff banks have no conversion costs, so the percent earnings reduction estimates shown in Table 6 are based strictly on earnings losses from NOW induced demand deposit outflows. Of the 16 runoff banks, 11 experienced estimated earnings losses from NOWs of less than 20 per cent of total earnings in both 1974 and 1975. In 1975, earnings reductions exceeding 50 per cent of total earnings are projected for three banks, with one of these banks suffering greater than a 100 per cent reduction.

Summary of Marginal Bank Earnings Reductions

As shown in the last two columns of Table 6, about 40 per cent of the 39 marginal banks experienced NOW related earnings reductions of less than 10 per cent in 1974, and 60 per cent suffered less than 20 per cent reductions. Five banks--or less than 15 per cent of the 39 banks--are estimated to have lost 50 per cent or more of 1974 earnings, including one bank which lost more than 100 per cent. However, as noted, this bank had only small NOW costs, but suffered from abnormally low earnings even without the NOW offset.

In 1975, about two-thirds of the 39 banks are estimated to have suffered relatively modest--less than 20 per cent--earnings reductions. Many banks experienced healthy demand deposit growth in 1975, thus helping to reduce estimated NOW losses. Also, Treasury bill rates--which are used to measure earnings losses from outflows--have been significantly lower in 1975 than in 1974. Six CBs, however, are projected to lose 50 per cent or more of 1975 earnings, and of these, two could lose more than 100 per cent.

The distribution of earnings reductions in these two columns suggests that even within the class of marginal banks, only a small number, perhaps 15 per cent, are presently experiencing significant adjustment problems. Of these, some may continue to experience severe adjustment problems, while others, such as those with temporarily low income due to other causes, many recover from NOW related earnings reductions without further problems. In addition, several runoff banks, by their own admission, have not really suffered NOW related deposit and earnings losses, but rather have lost demand deposits for other reasons.

Portfolio Adjustments by Marginal Banks[10/]

CBs an attempt to offset higher NOW costs and lower earnings in two basic ways; by lowering costs by imposing relatively high service charges on NOW accounts, and by raising revenues in any number of ways. As indicated briefly in Section III, there is limited evidence, mostly of a judgmental nature, that CB service charges on NOW accounts are higher on average than those imposed on demand deposits; thus a part, probably small, of increased NOW costs are being recovered through higher service charges.

10/ For a discussion of portfolio adjustments of thrifts, see Appendix B.

CBs an attempt to increase revenue by raising loan rates. However, in Massachusetts and New Hampshire, where stiff competition exists from banks in neighboring states and from money market obligations, such as strategy would likely be counterproductive. CBs can also attempt to raise earnings by including in their portfolios more risky, higher yielding assets. For example, a CB can usually increase revenues by selling short-term highly liquid assets such as Treasury bills, and using the proceeds to acquire non-prime business or real estate loans. The problem with this strategy is that the acquisition of more loans increases both the level of average earnings and the variation of these earnings. Increased variation in earnings, moreover, increases the probability of bank failure. Thus, portfolio adjustments by CBs attempting to maintain a target level of earnings are of considerable importance in examining the stability of commercial banking.

Before reviewing empirical evidence on this matter, it should be noted that, on theoretical grounds, costs and portfolio risk should be directly related.[11/] Portfolio theory as developed in the last 25 years, however, suggests that rational wealth holders seek to balance benefits of higher rates of return against the disadvantages of additional risk when selecting an optimal portfolio of assets. This behavior, though implying somewhat more risk will be assumed when the return on bank capital declines, is generally incompatible with attempting to maintain a target level of earnings independent of portfolio risk whenever costs or revenues change. This suggest a willingness of bank shareholders to accept lower earnings in the event of a temporary increase in cost; thus only modest increases in the riskness of the bank

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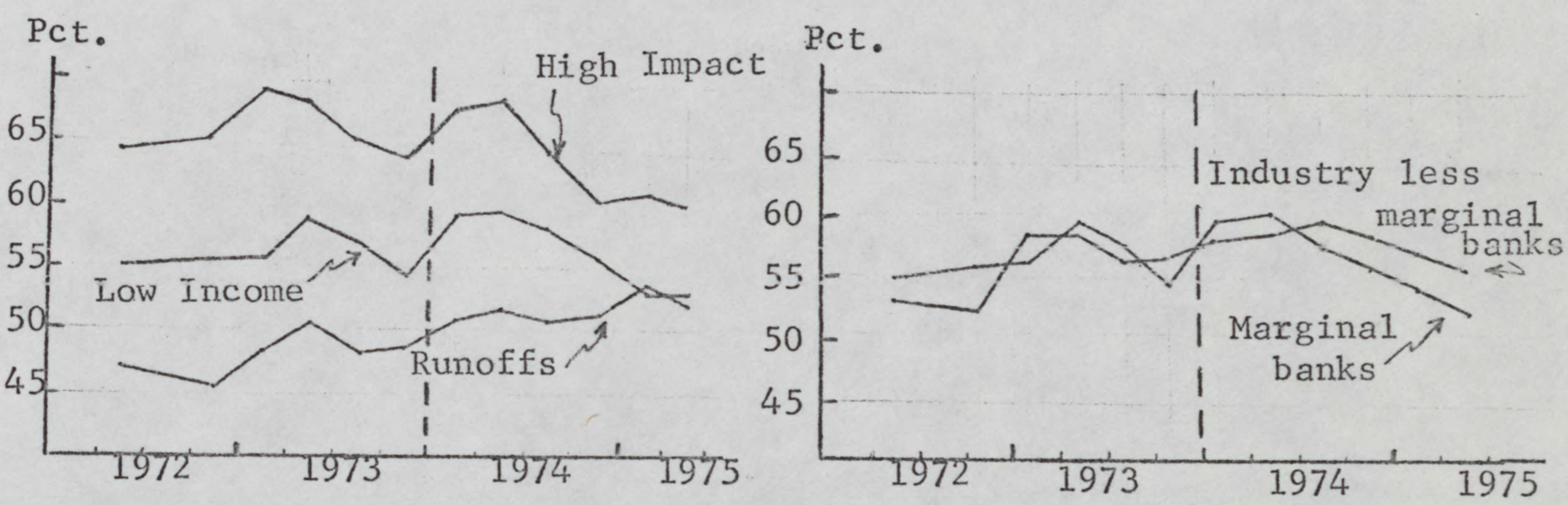
11/ See Ralph Gambs, "Interest Bearing Demand Deposits and Bank Portfolio Behavior", Southern Economic Journal, July 1975.

portfolio may result.

The hypothesis that the 39 marginal banks in Massachusetts and New Hampshire have attempted to increase portfolio risk in order to offset NOW related lower earnings can be examined by using the ratio of loans to total assets as a rough measure of risk for each bank. In the left panel of Figure 3, ratios of loans to total assets are shown for each of the three classes of marginal banks.

Figure 3



Since early 1974 these ratios have been gradually declining, and this would appear to contradict the "target rate of earnings" hypothesis of CB behavior. However, the economies of Massachusetts and New Hampshire were depressed during the 1974-75 period, so that loan demand was generally weak. Therefore, a comparison of loan ratios of marginal banks relative to all other Massachusetts and New Hampshire banks is shown in the right panel of Figure 3. Because the marginal banks experienced greater than average NOW related earnings losses, it might be expected that under the target rate of return hypothesis their loan to asset ratios might decline less than that of the industry. Instead, since late 1974, the aggregate marginal bank ratio, as shown in the right panel of Figure 3, has declined more than the industry ratio. Based on this evidence, the 39 marginal banks do not appear to have increased the riskiness of their portfolios, as measured by the ratio of loans to assets, as a result of NOW accounts.

V. THE LONG RUN ADJUSTMENT PROBLEM OF COMMERCIAL BANKS

Conversion of time and savings deposits to NOW accounts causes negligible cost increases, so the problem CBs face in the long run is absorbing, or offsetting, higher costs associated with conversions from demand deposits to NOWs and the loss of funds to thrifts. Because CBs have become quite successful in retaining NOW funds and hence face escalating costs of acquiring funds, the problem of absorbing such costs will be examined in some detail in the remainder of this section.

Characteristics of the Steady State

The Federal Reserve Board's Demand Deposit Ownership Survey indicates that 1/3 of all demand deposits are held by households; thus only about $2 billion of the $6 billion in demand deposits in Massachusetts and New Hampshire could therefore be converted to NOWs. In Table 2 it was shown that an estimated $550 million of demand deposits had been converted to NOWs as of September 1975. Thus, between 25 and 30 per cent of eligible transactions balances were at that time in NOW accounts.

It would be grossly incorrect, however, to attempt to obtain an estimate of the effect of NOWs on CB profits in the steady state--that period after which NOW market shares have stabilized and CBs have made all desired adjustments--by multiplying the September 1975 estimated earnings reductions (Tables 4 and 5) by some number such as 3 or 4. Such a calculation would be misleading because it ignores potential adjustments that CBs can make in competing for NOW funds.

Before the payment of interest on NOWs was permitted, CBs competed for transactions balances by offering suppliers of funds various non pecuniary services such as free checking, branch banking, longer hours of operation, and larger numbers of tellers to reduce waiting time. At the margin, however, the cost of providing such services exceeds the value attached to these services by customers. It is a widely accepted proposition, for example, that whenever the price of a service is set at zero, that service will be consumed by customers until the value of the last unit is zero. However, there is a positive cost associated with providing, or producing each service unit (e.g. the cost of clearing checks written against a "free" checking account is positive for each check). Thus, the provision of such services is inefficient in the sense that valuable resources are used up in producing services which, on the margin, have relatively low value.

By substituting pecuniary returns--the payment of interest on NOWs--for non pecuniary services, CBs can eliminate the waste, or inefficiencies, associated with providing non pecuniary services that have low marginal values relative to cost. Indeed, by permitting the payment of interest on NOW balances, both customers and banks can be expected to benefit. This can be shown by supposing that banks initially offer free checking services to the public and pay no interest on demand deposit balances. The total return on demand funds derived by customers is thus equal to the value of check cashing services, while the cost to the bank of acquiring demand balances is equal to the cost of servicing their customers' free checking accounts. If banks are allowed to make explicit interest payments to customers with demand funds on deposit, customers will be better off even if they are required to pay for check cashing services as long as the interest rate is high enough. Moreover, bank costs can be lowered due to reduced costs of servicing checking accounts if the interest rate is not set too high. Indeed, it is shown in Appendix C that there is a range if interest rates for which both customers--suppliers of demand deposits--and banks are better off--i.e. the total value of bank services to the customer, including interest earned, is higher and bank costs of providing these services are lower.

One important implication of this result--also discussed in Appendix C -- is that the cost to CBs of acquiring transactions balances will decline if banks are permitted to pay interest on such balances. This paradoxical result arises from the fact that removing a constraint on the way in which banks can compete for funds allows CBs to select a more efficient strategy for attracting funds.

Transition to the Steady State

Competitive pressures may make the transition to the steady state a long, and for some banks, a difficult process. However, after NOW growth begins to moderate and NOW market shares of individual CBs and thrifts stabilize, the aggressive competition for NOW funds should gradually disappear as the level of non pecuniary services is reduced.

To establish that rational pricing of NOW balances will indeed occur at some future date, it is necessary to show that the pricing policy now in effect of offering relatively high rates of return (including both pecuniary and non pecuniary returns) on a new claim such as a NOW account is neither surprising irrational, but represents a short run strategy consistent with maximizing the sum of current plus discounted future earnings. In Appendix D, a formal argument is presented showing that when the future supply of funds arising from a new claim is related positively to market shares established during the period before such shares have completely stabilized, a bank seeking to maximize the value of stockholder's equity will temporarily pay higher rates for these funds than is consistent with short run profit maximization. As market shares begin to stablize, moreover, the rate of return offered will decline to the profit maximizing level. This implies that current CB behavior in competing aggressively for NOW funds is not inconsistent with stockholder objectives, and more important, as the NOW market "settles down", total rates of return offered on NOW accounts will decline.

The major type of non pecuniary return offered by CBs which can be easily adjusted is free checking, including free drafts and free account maintenance. In table 7, estimates of NOW costs based on Functional Cost Data from the Federal Reserve Bank of Boston are shown. The total annual cost of servicing a NOW account with a $1000 average balance is about $90, of which nearly half ($41.40) is attributable to non interest related costs. If a 10 cent charge were imposed on drafts, the cost of servicing an average NOW account would decline to about $80.

TABLE 7

NOW COSTS FOR A $1000 ACCOUNT

	Item Cost	Number of items per Month	Monthly Cost	Annual Cost
Drafts	$.09	11	.99	11.88
Deposits made	.15	2	.30	3.60
Outside checks Handled	.04	4	.16	1.92
Account Maintenance (Statements, etc.)	2.00	1	2.00	24.00
Total cost per account			3.45	41.40
Interest cost, $1000.00 Account			4.17	50.00
Total cost per month			$7.62	$91.40

Moreover, if account maintenance charges were introduced, this cost would drop to about $55. Since the cost of servicing a free checking account averages about $40, CBs offering such accounts would thus experience, as the transition period proceeds, only moderate increases in costs of acquiring transactions balances if customers are required to absorb draft and account maintenance charges.

Other adjustments which take longer to make--such as reducing the number of branch banks, constructing less elaborate bank buildings and the like--will be made later as competitive pressures force CBs to adopt more efficient strategies for acquiring deposits. These adjustments, as noted earlier, will lower CB costs and thereby provide a net gain to the economy through more efficient resource utilization.

APPENDIX A

EVIDENCE ON THE SOURCE OF NOW DEPOSITS

If a substantial portion of NOW balances represent conversions from demand deposits, then demand deposit levels in Massachusetts and New Hampshire should have been lowered by NOW accounts. Similarly, savings deposits, being only marginally affected, should have grown at normal rates during the last two years. As shown in columns 1 and 2 of Table A-1, demand deposit balances in Massachusetts and New Hampshire did decline some $300 million in 1974. Moreover, balances in savings accounts increased about $300 million over this period. Part of the decline in demand deposits and part of the increase in savings, however, can be attributed to cyclical and regional economic factors. An attempt to adjust for these factors is therefore made in column 3 where projections of demand and savings deposit growth are shown. These projections are based on the assumption that in the absence of NOWs, demand and savings balances would have grown at the same rate as the average of those two series in the four neighboring New England states which did not offer NOWs. Thus, the projected levels represent an estimate of demand and savings balances that would have occurred had NOWs not been introduced, and the difference between columns 2 and 3 represents a rough estimate of the effect of NOW accounts on demand and savings deposit balances.

TABLE A-1

SOURCE OF NOW DEPOSITS
($ billions)

	(1) 1973.4	(2) Actual 1974.4	(3) Proj. 1974.4	(4) Diff. (2)-(3)	(5) Actual 1975.2	(6) Proj. 1975.2	(7) Diff. (6)-(7)
IPC demand	6.329	6.025	6.244	-.219	6.280	5.853	-.427
Savings deposits excluding NOWs	13.885	14.160	14.194	-.028	15.268	15.100	-.168
NOW accounts	.143	.340		.197*	.580		.437*

* Actual growth.

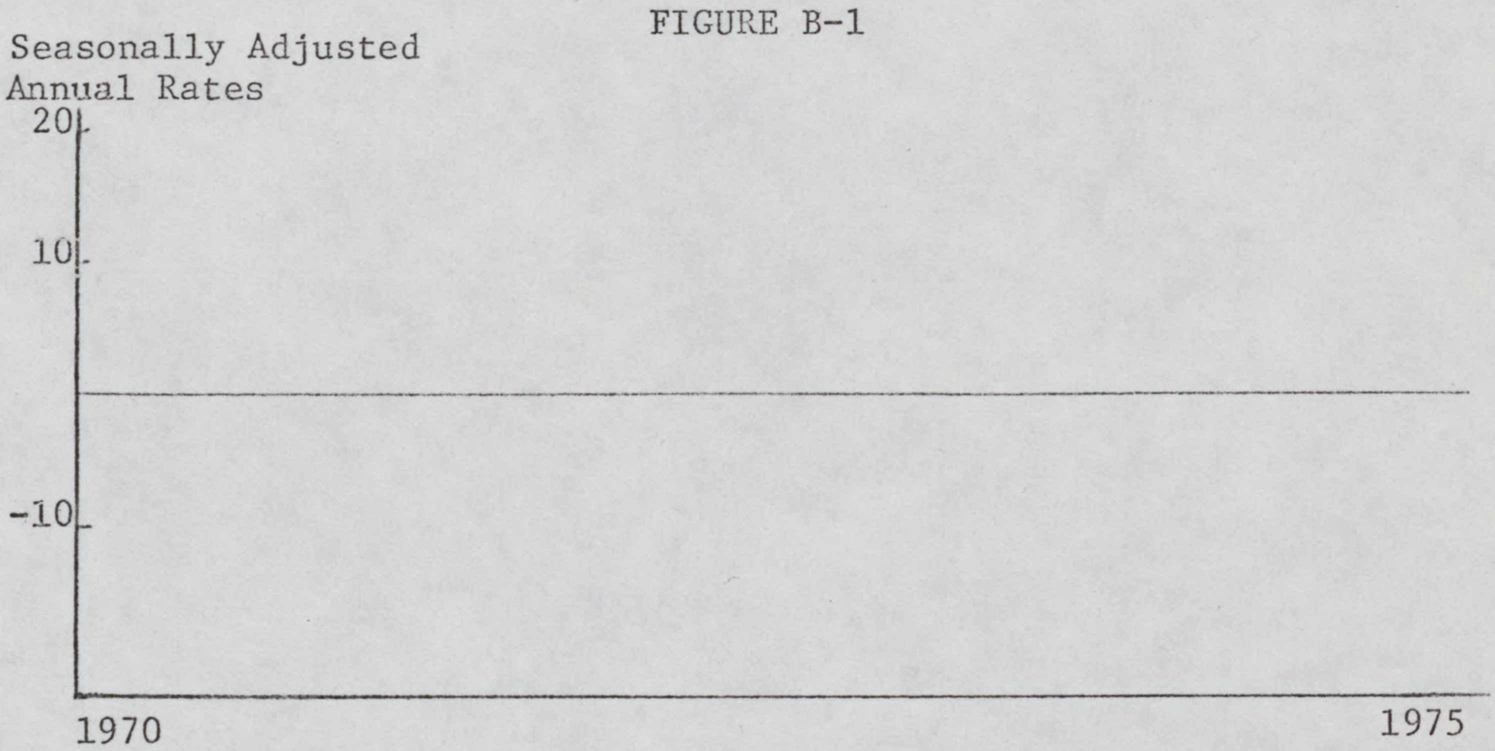
This difference, as shown in column 4, indicates that actual demand deposit growth in 1974 was some $220 million less than projected in Massachusetts and New Hampshire. Moreover, balances in savings accounts were only about $30 million below expected levels. The $220 million reduction in demand deposits in 1974 is almost completely offset by the $197 million increase in NOW balances, shown in the last row of Table A-1, suggesting that a significant portion of NOWs originated in CB demand deposits. Similar calculations, appearing in columns 6 and 7, for the 18 month period from January 1974 to June 1975 also indicate that, over the longer period, demand deposits have probably been the major source of funds for new NOW balances.

APPENDIX B

PORTFOLIO ADJUSTMENTS BY THRIFTS

Several important implications for thrift asset management arise from permitting MSBs and S&Ls to issue NOW accounts. Since they have developed as a very close substitute for checking accounts, NOW accounts should have short run and cyclical stability characteristics similar to those of demand deposits. Specifically, NOWs can be expected to be relatively more stable over the business cycle than time and savings deposits. For example, figure 4 presents some evidence on the cyclical

FIGURE B-1



stability of demand deposits relative to that of time and savings deposits at CB's and thrifts. Comparing the movements of the two series over the period shown, there is a clear indication that demand deposits are more stable over long periods of time than time and savings deposits. This evidence is supported by econometric studies which indicate that the sensitivity of time and savings flows to changes in market interest rates is much greater than that of demand deposits.

The acquisition of transactions balances by thrifts in the form of NOW accounts should, therefore, reduce the severity of the so-called disintermediation problem usually experienced by these institutions during periods of high market interest rates and, thereby, reduce the variation of earnings over the business cycle. However, the implications of thrift issuance of NOWs for mortgage lending are less clear. Research by Hester and Pierce[1/] suggests that depository institutions tend to allocate a significantly larger proportion of time and savings funds to real estate loans than demand funds. For example, using a model of CB asset management, Hester and Pierce estimate that approximately 30 cents of an additional dollar derived from time and savings deposits will be invested in real estate loans, while only 5 to 10 cents of an additional dollar of demand deposits will be similarly invested.[2/] Permitting thrifts to issue NOW accounts should, therefore, result in greater diversification of thrift asset portfolios as relatively large proportions of NOW funds are invested in short-term assets such as Treasury bills and consumer loans.

1/ Hester, Donald and James Pierce, op. cit.
2/ Though demand deposits are more stable than time and savings deposits over the business cycle, they are much more volatile over shorter periods of time such as a week. Thus, portfolio managers are reluctant to invest large proportions of demand funds in mortgages, since a demand deposit run-off within a few weeks might require that such assets be sold at a loss.

Total mortgage lending by all depository institutions might still increase, however, as a result of permitting thrifts to issue NOW accounts. The net effect on such lending of flows of funds between CBs and thrifts, through small, should be positive, since thrifts have a comparative advantage in mortgage lending. More important, however, is the extent to which CB time and savings deposit funds accompany the outflows of demand funds from CBs to thrifts. If, through the issuance of NOWs, thrifts are able to increase their share of the time and savings market, the net effect on mortgage lending could be significant, since thrifts invest more than 70 per cent of such funds in mortgages, compared to perhaps 30 per cent by CBs.

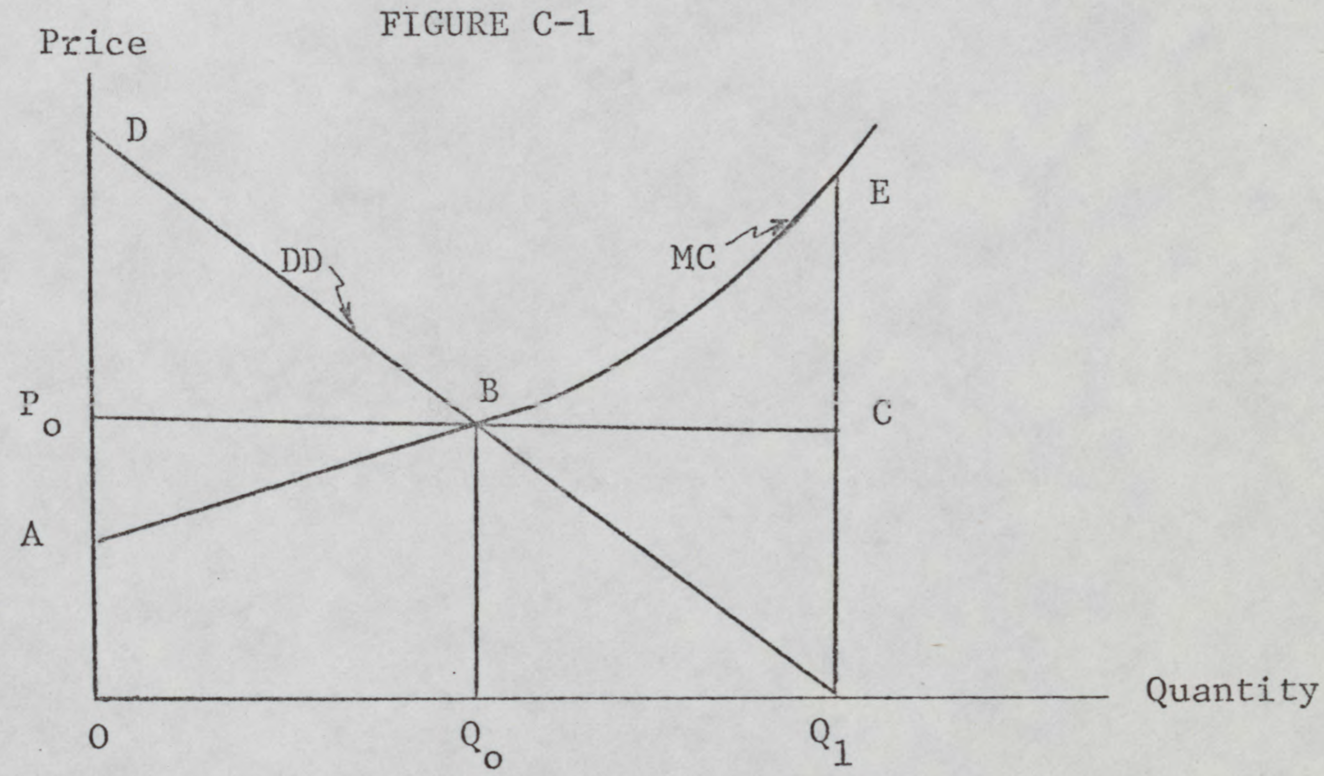
As noted in Section II, there is no evidence, as yet, of such a shift in market shares in Massachusetts and New Hampshire; thus there is no reason to expect that major changes in mortgage lending are imminent. However, if the present 1/4 point differential on passbook savings between CBs and thrifts is maintained, large outflows of CB savings funds associated with demand deposit flows might occur after the adjustment to NOWs is complete. Such a change in market shares could then significantly increase mortgage lending at the expense of other types of loans traditionally provided by CBs.

APPENDIX C

REMOVAL OF INTEREST RATE CONSTRAINTS,
BANK COSTS OF ACQUIRING FUNDS, AND
PORTFOLIO RISK*

Suppose that banks can initially offer only non pecuniary services--free checking, long hours, impressive buildings, etc.--in order to attract transactions deposits. The demand for these services is given by the curve DD in figure C-1, while the MC curve represents the marginal cost to the bank of providing such services.

FIGURE C-1



If the price of non pecuniary services is set at zero--as it is for all banks that offer free checking--the quantity demanded of non pecuniary services will be OQ_1. The area under the DD curve--the area of triangle ODQ_1--thus represents the total value of these services to the customer. The cost of providing this level of services, ignoring fixed costs, is equal to the area under the MC curve--the area of $OAEQ_1$.

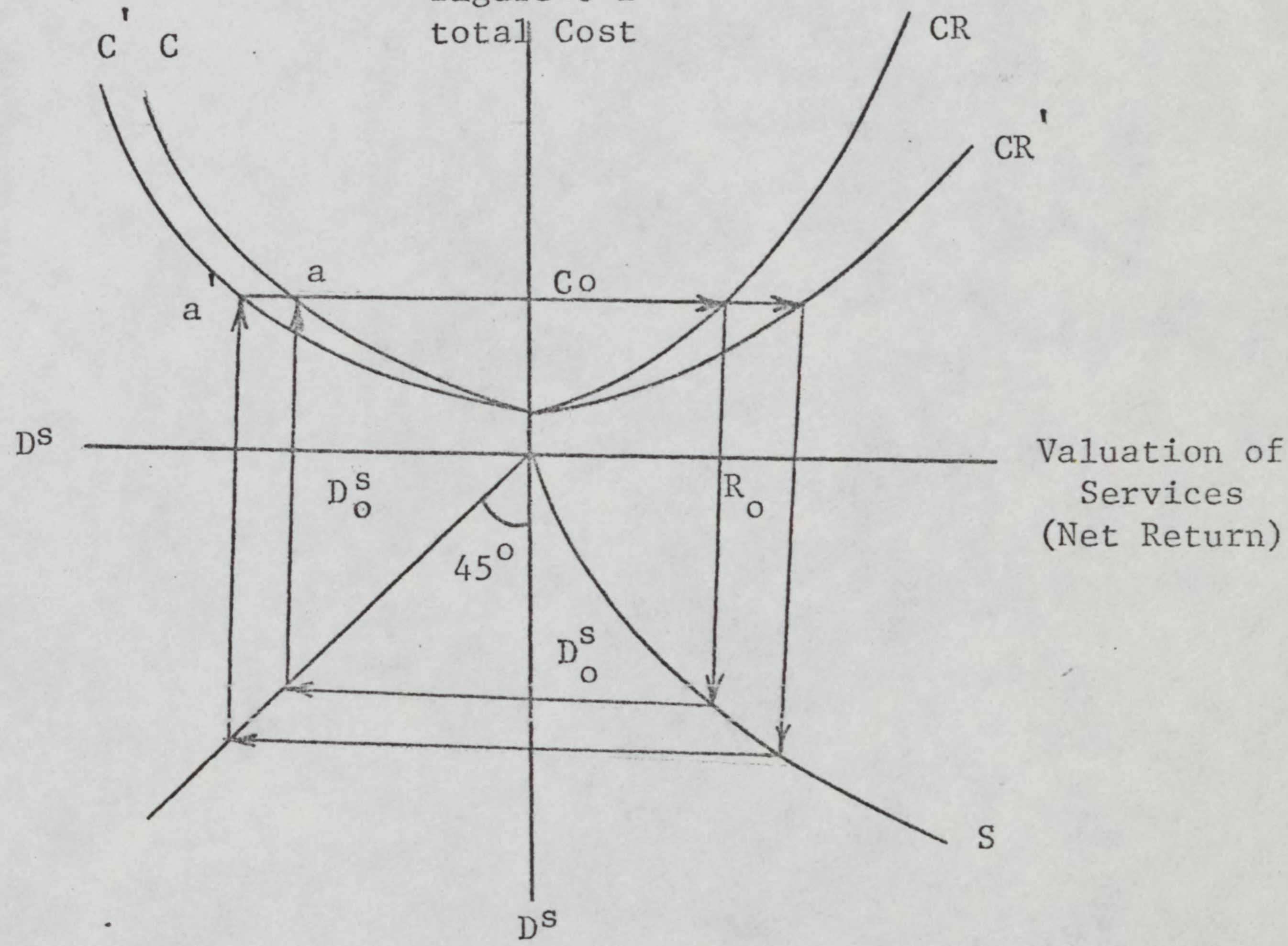
* It is assumed throughout this appendix that bank customers are relatively homogenous and that the number of checks written is positively related to the average balance of each account.

From figure C-1 it is clear that the cost of providing services beyond OQ_o exceeds the value attached to such services by customers. If permitted to pay interest on these funds, banks can eliminate this inefficiency, and still provide customers with the same or greater level of total--pecuniary plus non pecuniary--services. Moreover, the cost of providing this level of services will be lower.

For example, suppose banks change customers P_o for non pecuniary services. The level of such services "purchased" by customers will then be OQ_o which yields a net return to customers equal to the area of the triangle P_oDB (which is equal to the area under the demand curve between O and Q_o less the cost paid for services--equal to OP_oBQ_o). Suppose further that the interest rate is the set at a level to yield customers a pecuniary return equal to the area of OP_oCQ_1. The total return to customers is then equal to the area under the demand curve plus the area of the triangle BCQ_1. The cost to the bank of providing these services is equal to the area under the marginal cost curve between O and Q_o plus the area of the rectangle BCQ_1Q_o. This is less than the area under MC between O and Q_1--the original cost of non pecuniary services--by the area of BEC. Thus, by paying this particular interest rate on funds, total returns to customers are increased, while bank costs have declined. Moreover, any interest payment greater than OP_oBQ_1 but less than OP_oBEQ_1 will similarly raise total returns to customers while lowering bank costs.

This result can be easily extended to show that the cost of funds will decline if banks are permitted to pay interest on deposits. In the northeast quadrant of figure C.2, let the curve CR describe the relationship between bank costs of providing services and the valuation of those services by customers. Next, in the southeast

figure C-2



quadrant, let the curve S represent the customers' supply function of funds. This curve has the usual property that as total returns offered by banks increase, the supply of funds rises.

The cost of acquiring funds is depicted by the curve C in the northwest quadrant of figure C-2. This curve is derived from the CR and S curves by use of the 45 degree translation line in the southwest quadrant. For example, if bank costs are C_o, the level of services offered to customers will be R_o. According to the supply function S, customers will then supply D^s_o in funds. Thus, deposits totaling D^s_o are supplied when bank costs are C_o, as indicated by the point a in the northwest quadrant.

The payment of interest on deposits shifts the CR curve to the right to C R$'$, since, as ~~shown,~~ a higher return to customers can be achieved by a given expenditure of bank funds. It is easily seen from figure C-2 that this shift causes the C curve to shift downward to C'. Thus, by removing the constraint against the payment of interest on transactions balances--and thereby permitting banks to adopt a more efficient strategy for attracting funds--the cost to banks of acquiring funds will decline.

Finally, the lowering of the C curve has implications for the amount of portfolio risk a bank will undertake. It has been shown[1/] in the context of a mean-variance portfolio model[2/], that if bank owners have a quadratic utility function[3/], the amount of portfolio risk a bank will undertake rises whenever the risk-return curve shifts downward, and declines when an upward shift occurs. The lowering of the C curve in the steady state would tend to raise the mean-variance curve. Thus, in the long run bank portfolio risk might be lowered as a result of the payment of interest on transaction balances. In the short fun, the C curve is raised

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1/See Ralph Gambs, op. cit.

2/The mean-variance portfolio model was developed by Harry Markowitz, Portfolio Selection, Efficient Diversification of Investments, New York: John Wiley & Sons, 1959 and James Tobin,"Liquidity Preference as Behavior Towards Risk", Review of Economic Studies, February 1958. For a comprehensive review of portfolio theory including recent developments, see Michael Jensen, "Capital Markets: Theory and Evidence", Bell Journal of Economics and Management Science, 1972.

3/Quadratic, that is, in the mean and variance of the distribution of expected returns.

and the mean-variance curve is lowered, thus implying that portfolio risk might increase. However, as noted in Section IV, there is no evidence as yet of such a change in the riskiness of bank assets.

APPENDIX D

PROFIT MAXIMIZATION AS A SUB-OPTIMAL CRITERION WHEN THE LONG RUN SUPPLY OF FUNDS DEPENDS ON MARKET SHARES ESTABLISHED DURING A TRANSITION PERIOD

Suppose a new bank liability is introduced and that the long run supply of funds to each bank depends positively on the market share established during a transition period. Suppose further that the bank wishes to maximinize the sum of current plus future discounted profits. For a two period world the formal problem is:

$$\text{maximinimize} \quad W = \Pi_t + \frac{1}{\rho} \Pi_s$$

where $\Pi_t = (i_t - r_t)\, D_t$ profits during the transition period

$\Pi_s = (i_s - r_s)\, D_s$ profits in the steady state

ρ is a discount rate

i_t is the rate earned on investments during the transition period.

r_t is the offering rate on the new liability during the transition period $(r_t < i_t)$

i_s is the rate earned on investments in the steady state

r_s is the offering rate in the steady state $(r_s < i_s)$

The supply functions have the forms:

$D_t = D_t(r_t)$ $\quad \frac{\partial D_t}{\partial r_t} > 0$ (Supply function during transition)

$D_s = D_s(r_s, D_t)$ $\quad \frac{\partial D_s}{\partial r_s}, \frac{\partial D_s}{\partial D_t} > 0$ (Supply function in steady state)

Note that the supply of ~~funds during the~~ transition period depends positively on the offering rate, while the supply ~~in the~~ steady state, or long run, depends positively on the market share---D_t--established during the transition in addition to the offering rate.

To maximinize W (wealth), we differentiate with respect to r_t and r_s and set both expressions to zero:

$$\frac{\partial \Pi_t}{\partial r_t} + \frac{1}{\rho} \frac{\partial \Pi_s}{\partial r_t} = 0$$

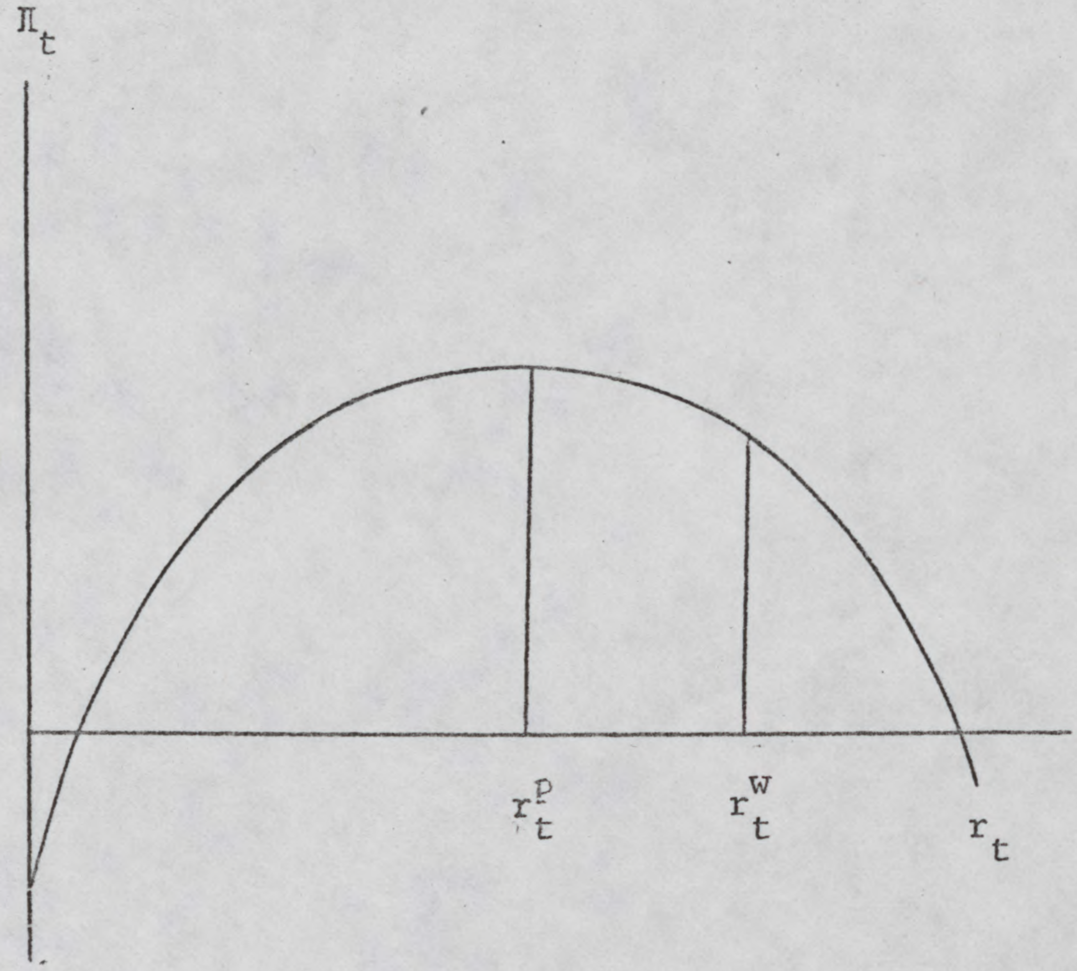
$$\frac{1}{\rho} \frac{\partial \Pi_s}{\partial r_s} = 0$$

Differentiating Π_s with respect to r_t yields

$$\frac{\partial \Pi_s}{\partial r_t} = (i_s - r_s) \frac{\partial D_s}{\partial D_t} \frac{\partial D_t}{\partial r_t} > 0$$

Because $\partial \Pi_s / \partial r_t$ is positive, the partial derivative $\partial \Pi_t / \partial r_t$ must be negative if the first order profit maximinization conditions are to be satisfied (first equation above). This implies that if the first period profit function is concave with respect to r_t, as is usually assumed, then the rate r_t that maximizes wealth is <u>greater</u> than the first period profit maximizing rate. This is shown in figure D-1, where r_t^p and r_t^w are the transition period profit and wealth maximizing prices respectively. Notice that r_t^w--the rate offered by a bank maximizing wealth (or, equivalently, stockholders equity)--is higher than r^p; this follows from $\partial \Pi_t / \partial r_t$ being negative.

Figure D-1



Finally, the condition $\partial\Pi_2/\partial r_s = 0$ implies that in the steady state, after market shares have stabilized, rate setting will be based on traditional profit maximizing considerations

FEDERAL RESERVE

press release

For immediate release March 1, 1976

The Board of Governors of the Federal Reserve System today amended its Regulation Q to permit member commercial banks throughout New England to offer NOW accounts to their customers.

The action was taken in light of legislation effective February 27, 1976, authorizing NOW accounts in four additional New England States. Congress previously authorized NOW accounts in Massachusetts and New Hampshire on an experimental basis.

A customer holding a NOW account may write Negotiable Orders of Withdrawal (NOWs) against the account and at the same time receive interest on the funds retained in the account.

Attached is a copy of the amendment to Regulation Q, which governs the payment of interest on deposits by member banks.

\- 0 -

TITLE 12--BANKS AND BANKING

CHAPTER II--FEDERAL RESERVE SYSTEM

SUBCHAPTER A--BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

[Regulation Q]

Part 217--Interest on Deposits

Technical Amendments for Deposits
Subject to Negotiable Orders of Withdrawal

The Board of Governors of the Federal Reserve System has amended Regulation Q (12 CFR 217) in light of recent legislation (P.L. 94-222) authorizing negotiable orders of withdrawal (NOW) accounts in the States of Maine, Connecticut, Rhode Island, and Vermont. The amendments are technical in nature and are intended only to extend the existing provisions of Regulation Q regarding the offering of NOW accounts to member banks in those States in which Federal law permits such accounts. The amendments also clarify the types of depositors that may be offered NOW accounts by member banks.

The first amendment adds a sentence to § 217.1(e)(3) to make clear the fact that NOW accounts may not be maintained where any beneficial interest is held by a corporation, partnership, association, or other organization operated for profit or not operated primarily for religious, philanthropic, charitable, educational, fraternal, or other similar purposes. In addition, the provision relating to maintenance of NOW accounts established prior to May 16, 1975, by certain governmental units has been eliminated because all such accounts were required to have been terminated by December 31, 1975 (see 40 FR 17885).

The second amendment eliminates the reference to the States of Massachusetts and New Hampshire contained in § 217.5(c)(3) to provide that the restrictions relating to manner of payment of savings deposits do not apply to deposits subject to negotiable orders of withdrawal, the issuance of which is authorized by Federal law.

The final amendment modifies § 217.6(i) to limit NOW account advertising of member banks, to the extent practicable, to media directed toward residents of the States in which Federal law authorizes such accounts and eliminates references to Massachusetts and New Hampshire. The provision also restricts all other solicitations of NOW accounts, to the extent practicable, only to persons residing or employed in the States in which Federal law authorizes such accounts and to persons who are customers of member banks in those States on the effective date of this amendment.

This action was taken pursuant to the Board's authority under § 19 of the Federal Reserve Act (12 U.S.C. 371b) to prescribe rules governing the payment and advertisement of interest on deposits.

Because these amendments are technical in nature only and do not result in any substantive changes to the provisions of Regulation Q, the Board finds that good cause exists for dispensing with notice and public participation referred to in § 553(b) of Title 5 of the

United States Code with respect to these amendments. The Board has determined that such procedures are unnecessary in view of the nature of the amendments. In addition, in view of the technical nature of the amendments and in order to enable member banks to offer NOW accounts to the public as soon as possible, the Board finds good cause to make the amendments effective immediately.

Pursuant to § 19 of the Federal Reserve Act (12 U.S.C. 371b) effective March 1, 1976, § 217 of Regulation Q (12 CFR 217) is amended to read as follows:

§ 217.1--DEFINITIONS

* * * * *

(e) <u>Savings deposits</u>

* * * * *

(3) In those States where banks are permitted to offer deposits subject to negotiable orders of withdrawal, such deposits may be maintained if such deposits consist of funds deposited to the credit of or in which the entire beneficial interest is held by one or more individuals, or a corporation, association, or other organization operated primarily for religious, philanthropic, charitable, educational, fraternal, or other similar purposes, and not operated for profit. Deposits in which any beneficial interest is held by a corporation, partnership, association or other organization operated for profit or not operated primarily for religious, philanthropic, charitable, educational, fraternal, or other similar purposes may not be classified as deposits subject to negotiable orders of withdrawal.

* * * * *

§ 217.5--WITHDRAWAL OF SAVINGS DEPOSITS

* * * * *

(c) Manner of payment of savings deposits

* * * * *

(3) The provisions of this paragraph do not apply to deposits subject to negotiable orders of withdrawal that are authorized by Federal law.

* * * * *

§ 217.6--ADVERTISING OF INTEREST ON DEPOSITS

* * * * *

(i) Negotiable orders of withdrawal.

In addition to compliance with the other paragraphs of this section, member banks offering accounts subject to negotiable orders of withdrawal, to the extent practicable, shall limit every advertisement, announcement or solicitation made in any newspaper, magazine, radio, television or other media to such facilities directed toward residents of the States in which Federal law authorizes the issuance of such accounts. All other advertisement, announcements and solicitations of such accounts, including direct mailing, circulars, and notices, whether written or oral, to the extent practicable, shall be directed only to persons residing or employed in the States in which Federal law authorizes the issuance of accounts subject to negotiable orders of withdrawal and to persons who are customers of member banks in those States on the effective date of this amendment.

By order of the Board of Governors, effective March 1, 1976.

(Signed) Theodore E. Allison

Theodore E. Allison
Secretary of the Board

[SEAL]

February 10, 1976

To: Board of Governors

From: Don Winn DW

The House has now given final approval to S. 2672 thereby clearing the measure for the President. This is the bill which extends the moratorium on the interstate taxation of depository institutions, allows NOW accounts in all six New England States, and makes certain changes in the Fair Credit Billing Act. The NOW account provision goes into effect immediately upon date of enactment.

cc: Messrs. Allison, Garwood, Coyne, O'Brien, Hawke, Gramley, Raiken, F. Solomon, Kluckman, Kichline, Eckert, Ettin, and Ms. Hart

February 9, 1976

To: Board of Governors

From: Don Winn DW

On Friday, February 6, the Senate, after adding minor amendments, agreed to the House version of S. 2672, the bill which would extend the moratorium on interstate taxation of depository institutions to September 12, 1976.

This bill would also allow all Federal financial institutions in the 6 New England states to offer NOW accounts.

It is the third section of the bill with its provisions amending the Fair Credit Billing Act that has been the subject of disagreement between the House and Senate.

-- The Senate has now agreed to the House provision authorizing the Federal Reserve Board to delegate to staff the authority to issue binding interpretations and approvals.

-- The Senate has also agreed to the House provision to specifically prohibit the imposition of surcharges on credit card customers. The Senate, however, has added the modification that the ban on surcharges would be limited to a 3 year period so that Congress would review the matter at a later time.

-- The House bill would have eliminated the 5 per cent limitation on permissible cash discounts. The Senate disagreed with this provision and has added an amendment to reinstate the 5 per cent limit.

The bill now returns to the House for final approval, which is expected without further changes.

cc: Messrs. Allison, Garwood, Coyne, O'Brien, Hawke, Gramley, Raiken, F. Solomon, Kluckman, Kichline, Eckert, Ettin, and Ms. Hart

30.270

December 8, 1975

To: Board of Governors

From: Don Winn DW

The Senate today approved an extension of the moratorium on interstate taxation of national banks from December 31, 1975, to September 12, 1976. It also accepted by a voice vote an amendment by Senator Brooke authorizing NOW accounts in all the New England states.

Also, the Senate passed legislation repealing provisions of the Real Estate Settlement Procedures Act. An amendment recommended by the Board was adopted to allow advance disclosure of credit costs. The language of the amendment reads as follows:

(c) For the purposes of subsection (a), the Board is authorized to require by regulation the disclosure of all or part of the information required to be disclosed under this Chapter at the time a creditor makes a written commitment with respect to a consumer credit transaction involving real property which is used or is expected to be used as the principal residence of the person to whom the credit is extended.

cc: Messrs. Allison, Garwood, Coyne, O'Brien, Hawke, Solomon, Raiken, Kluckman, Kichline, Ettin, Boltz, Eckert, and Ms. Hart.

November 18, 1975

To: Chairman Burns
Thru: Ken Guenther
From: Don Winn

At your request I have talked to Governor Mitchell about the possible McIntyre legislation to extend NOW account powers to Federal S&L's in states like Maine and Connecticut which are giving demand deposit powers and NOW account powers to state chartered thrift institutions.

Governor Mitchell feels that in New England the S&L's are a relatively small part of the market so that extending NOW account powers to Federal S&L's would not have an important effect on commercial banks and it would equalize the Federal S&L's with the state chartered thrifts. He feels that it would be entirely different if the extension were to apply to states outside New England where S&L's have a much larger market share.

Attached is a table showing market shares in Connecticut and Maine, which Governor Mitchell referred to.

Governor Mitchell also suggested that we say to McIntyre that we would have to consider removing the differential if the change were to result in a worsening of competitive positions.

Shall I indicate to McIntyre's staff (and this would be off the record) that the Board would not object to extending NOW account powers to Federal S&L's in New England, but that the Board would take a different position if the legislation affected other geographic areas?

Yes ____

No ____

I asked Governor Mitchell if we should take the position that NOW account powers should also be given to commercial banks. He did not think this was necessary. He said that the commercial bank share of the market was increasing and that there was no evidence they would be hurt.

Attachment

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

Office Correspondence

Date February 20, 1975

To Board of Governors

Subject: NOW account developments in December 1974

From Paul W. Boltz

After one full year of the Congressionally-mandated NOW account experiment in Massachusetts and New Hampshire, outstanding balances in NOW accounts in the two states have more than doubled to $313 million, and the pace of growth accelerated in the second half of the year. At the present rate, outstanding NOW account balances will double approximately every 8 months. However, although they have spread at a rapid rate, they still are less than 1 per cent of total deposits and less than 4 per cent of demand deposits at depository institutions in the two states.

At the end of the year, 75 per cent of the 201 mutual savings banks in the two states were offering NOW accounts, up from 50 per cent at the beginning of the year. Savings and loan associations entered the field very rapidly in 1974, and at the end of December over 40 per cent of the 197 S&L's in the two states were offering NOW accounts. Commercial banks have not matched the aggressive entry of the S&L's into the NOW market, and at the close of the year only 28 per cent of banks had NOW accounts. Altogether, 47 per cent of the 627 depository institutions in the two states were offering NOW accounts as of December 31, 1974. The more rapid entry of thrift institutions into the NOW market likely reflects their desire to compete with commercial banks in the payments market. Since banks already had demand deposits, their slower entry may reflect their prior position of strength in this market.

Activity levels at NOW accounts gradually rose over the year. New Hampshire MSB's, which pioneered NOW accounts with no-charge drafts that paid low interest, had the highest average level of NOW account activity in January 1974 when data were first collected. At that time, 75 per cent of New Hampshire's MSB's that offered NOW accounts provided free drafts, and the proportion of other institutions offering free NOW drafts in the two states was much lower. Other institutions switched to free drafts as the year progressed or offered them when they first entered the NOW market. Most institutions switching to free drafts continued paying the ceiling rate of 5 per cent, and to compete with them, institutions just entering the field also paid the ceiling rate on their free-draft NOW accounts. Consequently, the accounts have evolved into very attractive accounts for transactions balances. As the following table shows, NOW account activity at New Hampshire MSB's is being approached at other institutions.

1974 NOW Account Activity in Massachusetts and New Hampshire

	Average number of NOW drafts per account		Percentage of NOW accounts with over 20 drafts	
	January	December	January	December
Massachusetts				
Commercial banks	6.8	8.5	0.0	11.0
MSB's	6.8	9.2	3.8	7.8
S&L's	4.9	10.6	0.0	10.8
Total Massachusetts	6.8	9.3	3.7	8.7
New Hampshire				
Commercial banks	4.1	11.0	0.0	15.5
MSB's	12.6	12.2	25.0	16.6
S&L's	**	10.3	**	14.0
Total New Hampshire	12.6	11.7	24.6	16.0
Total Massachusetts and New Hampshire	7.3	9.5	5.4	9.4

** In January, only one S&L in New Hampshire was offering NOW accounts, and its data were included with data on MSB's in New Hampshire by the Boston Federal Reserve Bank to protect the confidentiality of the report.

Interest Rates and Charges for Drafts on Now Accounts in Massachusetss and New Hampshire, 1974

	Percentage of institutions at ceiling rate		Percentage of institutions with free NOW drafts	
	January	December	January	December
Massachusetts				
Commercial banks	100.0	98.0	27.3	19.6
MSB's	100.0	100.0	25.9	70.2
S&L's	100.0	100.0	36.4	78.6
Total Massachusetts	100.0	99.6	27.1	62.3
New Hampshire				
Commercial banks	66.6	83.3	0.0	50.0
MSB's	13.3	45.0	75.0	70.0
S&L's	**	90.9	**	45.4
Total New Hampshire	21.0	67.4	63.2	58.1
Total Massachusetts and New Hampshire	88.1	94.9	32.5	61.7

** In January, only one S&L in New Hampshire was offering NOW accounts, and its data were included with data on MSB's in New Hampshire by the Boston Federal Reserve Bank to protect the confidentiality of the report.

One feature of the NOW accounts which has remained relatively stable over the year is the predominant method of interest calculation--from day of deposit to day of withdrawal. Almost all the mutual savings banks offering NOW accounts in January 1974 calculated interest in this way, and since then over 90 per cent of the institutions which began offering NOW's also calculated interest from day of deposit to day of withdrawal. Most institutions also compound the interest either continuously or daily, but the proportion has been falling slightly as the number of institutions compounding quarterly or monthly has grown. At the end of December about 70 per cent of the offering institutions compounded continuously or daily.

TABLE 1

NUMBER OF INSTITUTIONS OFFERING NOWS AND NOW BALANCES AS OF DECEMBER 31, 1974

(DOLLAR AMOUNTS IN THOUSANDS OF DOLLARS)

	NUMBER OF INSTITUTIONS		NOW BALANCES PREVIOUS MONTH	TRANSACTIONS DURING MONTH			SERVICE CHARGES	NOW BALANCES CURRENT MONTH
	TOTAL	OFFERING NOWS		AMOUNT OF INTEREST CREDITED	DEPOSIT INFLOWS	ALL WITH-DRAWALS		
MASSACHUSETTS								
COMMERCIAL BANKS	153	51	48,563	188	45,870	37,626	6	56,989
MEMBERS	92	33	23,876	71	21,504	16,482	5	28,964
NON-MEMBERS	61	18	24,687	117	24,366	21,144	1	28,025
MUTUAL SAVINGS BANKS	167	131	192,577	787	113,401	106,656	26	200,083
SAVINGS & LOAN ASSOCIATIONS AND COOPERATIVES	179	70	26,689	116	24,894	21,952	0	29,747
FSLIC INSURED - MEMBERS FHLB	35	21	11,534	63	12,018	10,409	0	13,206
STATE INSURED - MEMBERS FHLB	28	11	5,639	21	4,510	4,264	0	5,906
STATE INSURED - NON-MEMBERS FHLB	116	38	9,516	32	8,366	7,279	0	10,635
TOTAL MASSACHUSETTS	499	252	267,829	1,091	184,165	166,234	32	286,819
NEW HAMPSHIRE								
COMMERCIAL BANKS	76	12	7,431	27	6,104	5,302	0	8,260
MUTUAL SAVINGS BANKS	34	20	14,187	42	12,716	13,366	1	13,578
SAVINGS & LOAN ASSOCIATIONS AND COOPERATIVES								
FSLIC INSURED - MEMBERS FHLB	18	11	3,858	16	3,312	3,267	0	3,919
STATE INSURED - MEMBERS FHLB	0	0	0	0	0	0	0	0
STATE INSURED - NON MEMBERS FHLB	0	0	0	0	0	0	0	0
TOTAL NEW HAMPSHIRE	128	43	25,476	85	22,132	21,935	1	25,757
TOTAL MASSACHUSETTS AND NEW HAMPSHIRE	627	295	293,305	1,176	206,297	188,169	33	312,576

PREPARED BY STATISTICAL SECTION, RESEARCH DEPARTMENT, FEDERAL RESERVE BANK OF BOSTON

TABLE 2

NUMBER OF NOW ACCOUNTS AT OFFERING INSTITUTIONS

AS OF DECEMBER 31, 1974

	NUMBER OF NOW ACCOUNTS PREVIOUS MONTH	NEW ACCOUNTS OPENED DURING MONTH		NUMBER OF ACCOUNTS CLOSED DURING MONTH	NUMBER OF NOW ACCOUNTS CURRENT MONTH
		BY EXISTING CUSTOMERS (1)	BY NEW CUSTOMERS		
MASSACHUSETTS					
COMMERCIAL BANKS	39,986	3,637	2,718	673	45,668
MEMBERS	18,550	1,783	2,005	544	21,794
NON-MEMBERS	21,436	1,854	713	129	23,874
MUTUAL SAVINGS BANKS	196,125	6,583	5,422	2,426	205,704
SAVINGS & LOAN ASSOCIATIONS AND COOPERATIVES	34,048	1,967	1,587	354	37,248
FSLIC INSURED - MEMBERS FHLB	16,283	988	712	187	17,796
STATE INSURED - MEMBERS FHLB	6,329	175	281	50	6,735
STATE INSURED - NON-MEMBERS FHLB	11,436	804	594	117	12,717
TOTAL MASSACHUSETTS	270,159	12,187	9,727	3,453	288,620
NEW HAMPSHIRE					
COMMERCIAL BANKS	4,991	319	156	70	5,396
MUTUAL SAVINGS BANKS	18,475	662	224	166	19,195
SAVINGS & LOAN ASSOCIATIONS AND COOPERATIVES					
FSLIC INSURED - MEMBERS FHLB	3,586	194	232	48	3,964
STATE INSURED - MEMBERS FHLB	0	0	0	0	0
STATE INSURED - NON MEMBERS FHLB	0	0	0	0	0
TOTAL NEW HAMPSHIRE	27,052	1,175	612	284	28,555
TOTAL MASSACHUSETTS AND NEW HAMPSHIRE	297,211	13,362	10,339	3,737	317,175

(1) EXISTING CUSTOMERS ARE DEFINED AS THOSE HAVING AN ACCOUNT AT THE INSTITUTION AT THE TIME THE NOW ACCOUNT WAS OPENED.

PREPARED BY STATISTICAL SECTION, RESEARCH DEPARTMENT, FEDERAL RESERVE BANK OF BOSTON

TABLE 3 A

NOW ACCOUNT ACTIVITY

DURING THE MONTH OF

DECEMBER 31, 1974

	NUMBER OF NOW ACCOUNTS WITH ACTIVITY DURING MONTH OF: DECEMBER 31, 1974				TOTAL NUMBER OF NOW DRAFTS	AVERAGE NUMBER OF NOW DRAFTS PER ACCOUNT(2)
	NO DRAFTS	1-9 DRAFTS	10-20 DRAFTS	> 20 DRAFTS		
MASSACHUSETTS						
COMMERCIAL BANKS	17,279	16,142	7,204	5,043	241,438	8.5
MEMBERS	13,050	4,920	2,264	1,560	96,328	11.0
NON-MEMBERS	4,229	11,222	4,940	3,483	145,110	7.3
MUTUAL SAVINGS BANKS	48,551	102,171	38,840	16,142	1,455,646	9.2
SAVINGS & LOAN ASSOCIATIONS AND COOPERATIVES	8,442	15,578	9,193	4,035	306,140	10.6
FSLIC INSURED - MEMBERS FHLB	5,112	6,964	3,769	1,951	145,919	11.5
STATE INSURED - MEMBERS FHLB	1,240	2,983	1,720	792	59,822	10.8
STATE INSURED - NON-MEMBERS FHLB	2,090	5,631	3,704	1,292	100,399	9.4
TOTAL MASSACHUSETTS	74,272	133,891	55,237	25,220	2,003,224	9.3
NEW HAMPSHIRE						
COMMERCIAL BANKS	982	2,425	1,154	835	48,591	11.0
MUTUAL SAVINGS BANKS	3,075	7,956	4,987	3,177	197,175	12.2
SAVINGS & LOAN ASSOCIATIONS AND COOPERATIVES						
FSLIC INSURED - MEMBERS FHLB	641	1,905	863	555	34,302	10.3
STATE INSURED - MEMBERS FHLB	0	0	0	0	0	0.0
STATE INSURED - NON MEMBERS FHLB	0	0	0	0	0	0.0
TOTAL NEW HAMPSHIRE	4,698	12,286	7,004	4,567	280,068	11.7
TOTAL MASSACHUSETTS AND NEW HAMPSHIRE	78,970	146,177	62,241	29,787	2,283,292	9.5

(2) AVERAGE EXCLUDES THOSE ACCOUNTS WHICH HAD NO ACTIVITY DURING THE MONTH.

PREPARED BY STATISTICAL SECTION, RESEARCH DEPARTMENT, FEDERAL RESERVE BANK OF BOSTON

TABLE 3 B

NOW ACCOUNT ACTIVITY

DURING THE MONTH OF

DECEMBER 31, 1974

	PERCENTAGE OF NOW ACCOUNTS WITH ACTIVITY DURING MONTH OF: DECEMBER 31, 1974 (3)				NUMBER OF NOW ACCOUNTS CURRENT MONTH	AVERAGE BALANCE PER ACCOUNT
	NO DRAFTS	1-9 DRAFTS	10-20 DRAFTS	> 20 DRAFTS		
MASSACHUSETTS						
COMMERCIAL BANKS	37.8	35.3	15.8	11.0	45,668	1,247.90
MEMBERS	59.9	22.6	10.4	7.2	21,794	1,328.99
NON-MEMBERS	17.7	47.0	20.7	14.6	23,874	1,173.87
MUTUAL SAVINGS BANKS	23.6	49.7	18.9	7.8	205,704	972.67
SAVINGS & LOAN ASSOCIATIONS AND COOPERATIVES	22.7	41.8	24.7	10.8	37,248	798.62
FSLIC INSURED - MEMBERS FHLB	28.7	39.1	21.2	11.0	17,796	742.08
STATE INSURED - MEMBERS FHLB	18.4	44.3	25.5	11.8	6,735	876.91
STATE INSURED - NON-MEMBERS FHLB	16.4	44.3	29.1	10.2	12,717	836.28
TOTAL MASSACHUSETTS	25.7	46.4	19.1	8.7	288,620	993.76
NEW HAMPSHIRE						
COMMERCIAL BANKS	18.2	44.9	21.4	15.5	5,396	1,530.76
MUTUAL SAVINGS BANKS	16.0	41.4	26.0	16.6	19,195	707.37
SAVINGS & LOAN ASSOCIATIONS AND COOPERATIVES						
FSLIC INSURED - MEMBERS FHLB	16.2	48.1	21.8	14.0	3,964	988.65
STATE INSURED - MEMBERS FHLB	0.0	0.0	0.0	0.0	0	0.00
STATE INSURED - NON MEMBERS FHLB	0.0	0.0	0.0	0.0	0	0.00
TOTAL NEW HAMPSHIRE	16.5	43.0	24.5	16.0	28,555	902.01
TOTAL MASSACHUSETTS AND NEW HAMPSHIRE	24.9	46.1	19.6	9.4	317,175	985.50

(3) PERCENTAGES MAY NOT TOTAL EXACTLY 100 PERCENT DUE TO ROUNDING

PREPARED BY STATISTICAL SECTION, RESEARCH DEPARTMENT, FEDERAL RESERVE BANK OF BOSTON

TABLE 4 A

RATES PAID ON NOW ACCOUNTS

AS OF DECEMBER 31, 1974

(DOLLAR AMOUNTS IN THOUSANDS OF DOLLARS)

	3.0%		OVER 3.0% AND LESS THAN 4.0%		4.0%		OVER 4.0% AND LESS THAN 4.50%	
	NO OF INST	DOLLAR AMOUNT	NO OF INST	DOLLAR AMOUNT	NO OF INST	DOLLAR AMOUNT	NO OF INST	DOLLAR AMOUNT
MASSACHUSETTS								
COMMERCIAL BANKS	0	0	0	0	1	316	0	0
MEMBERS	0	0	0	0	0	0	0	0
NON-MEMBERS	0	0	0	0	1	316	0	0
MUTUAL SAVINGS BANKS	0	0	0	0	0	0	0	0
SAVINGS & LOAN ASSOCIATIONS AND COOPERATIVES	0	0	0	0	0	0	0	0
FSLIC INSURED - MEMBERS FHLB	0	0	0	0	0	0	0	0
STATE INSURED - MEMBERS FHLB	0	0	0	0	0	0	0	0
STATE INSURED - NON-MEMBERS FHLB	0	0	0	0	0	0	0	0
TOTAL MASSACHUSETTS	0	0	0	0	1	316	0	0
NEW HAMPSHIRE								
COMMERCIAL BANKS	0	0	0	0	2	569	0	0
MUTUAL SAVINGS BANKS	4	1,806	0	0	7	5,046	0	0
SAVINGS & LOAN ASSOCIATIONS AND COOPERATIVES								
FSLIC INSURED - MEMBERS FHLB	0	0	0	0	1	160	0	0
STATE INSURED - MEMBERS FHLB	0	0	0	0	0	0	0	0
STATE INSURED - NON MEMBERS FHLB	0	0	0	0	0	0	0	0
TOTAL NEW HAMPSHIRE	4	1,806	0	0	10	5,775	0	0
TOTAL MASSACHUSETTS AND NEW HAMPSHIRE	4	1,806	0	0	11	6,091	0	0

PREPARED BY STATISTICAL SECTION, RESEARCH DEPARTMENT, FEDERAL RESERVE BANK OF BOSTON

TABLE 4 B

RATES PAID ON NOW ACCOUNTS

AS OF DECEMBER 31, 1974

(DOLLAR AMOUNTS IN THOUSANDS OF DOLLARS)

	4.50%		OVER 4.5% AND LESS THAN 5.0%		5.0%		WEIGHTED AVERAGE RATE (4)
	NO OF INST	DOLLAR AMOUNT	NO OF INST	DOLLAR AMOUNT	NO OF INSTS	DOLLAR AMOUNT	
MASSACHUSETTS							
COMMERCIAL BANKS	0	0	0	0	50	56,673	4.994
MEMBERS	0	0	0	0	33	28,964	5.000
NON-MEMBERS	0	0	0	0	17	27,709	4.988
MUTUAL SAVINGS BANKS	0	0	0	0	131	200,083	5.000
SAVINGS & LOAN ASSOCIATIONS AND COOPERATIVES	0	0	0	0	70	29,747	5.000
FSLIC INSURED - MEMBERS FHLB	0	0	0	0	21	13,206	5.000
STATE INSURED - MEMBERS FHLB	0	0	0	0	11	5,906	5.000
STATE INSURED - NON-MEMBERS FHLB	0	0	0	0	38	10,635	5.000
TOTAL MASSACHUSETTS	0	0	0	0	251	286,503	4.998
NEW HAMPSHIRE							
COMMERCIAL BANKS	0	0	0	0	10 7	7,691	4.931
MUTUAL SAVINGS BANKS	0	0	0	0	9	6,726	4.362
SAVINGS & LOAN ASSOCIATIONS AND COOPERATIVES							
FSLIC INSURED - MEMBERS FHLB	0	0	0	0	10	3,759	4.959
STATE INSURED - MEMBERS FHLB	0	0	0	0	0	0	.000
STATE INSURED - NON MEMBERS FHLB	0	0	0	0	0	0	.000
TOTAL NEW HAMPSHIRE	0	0	0	0	29	18,176	4.635
TOTAL MASSACHUSETTS AND NEW HAMPSHIRE	0	0	0	0	280	304,679	4.968

(4) WEIGHTED BY DOLLAR AMOUNT

PREPARED BY STATISTICAL SECTION, RESEARCH DEPARTMENT, FEDERAL RESERVE BANK OF BOSTON

TABLE 5

METHOD OF INTEREST RATE CALCULATION

AS OF DECEMBER 31, 1974

(NUMBER OF INSTITUTIONS)

	INTEREST CALCULATED ON:					FREQUENCY OF COMPOUNDING				
	AVG DLY BAL	MIN BAL	DAY OF DEP TO WITH	DAY OF DEP TO DIV DT	OTHER	CONT	DAILY	MONTHLY	QTERLY	OTHER
MASSACHUSETTS										
COMMERCIAL BANKS	8	2	40	0	1	11	11	17	12	0
MEMBERS	5	0	27	0	1	7	6	11	9	0
NON-MEMBERS	3	2	13	0	0	4	5	6	3	0
MUTUAL SAVINGS BANKS	3	1	126	0	1	86	27	13	4	1
SAVINGS & LOAN ASSOCIATIONS AND COOPERATIVES	3	0	65	1	1	37	13	9	11	0
FSLIC INSURED - MEMBERS FHLB	1	0	19	0	1	10	7	1	3	0
STATE INSURED - MEMBERS FHLB	0	0	11	0	0	6	1	2	2	0
STATE INSURED - NON-MEMBERS FHLB	2	0	35	1	0	21	5	6	6	0
TOTAL MASSACHUSETTS	14	3	231	1	3	134	51	39	27	1
NEW HAMPSHIRE										
COMMERCIAL BANKS	0	1	10	0	1	0	2	10	0	0
MUTUAL SAVINGS BANKS	0	0	19	0	1	18	0	2	0	0
SAVINGS & LOAN ASSOCIATIONS AND COOPERATIVES										
FSLIC INSURED - MEMBERS FHLB	0	1	10	0	0	5	4	2	0	0
STATE INSURED - MEMBERS FHLB	0	0	0	0	0	0	0	0	0	0
STATE INSURED - NON MEMBERS FHLB	0	0	0	0	0	0	0	0	0	0
TOTAL NEW HAMPSHIRE	0	2	39	0	2	23	6	14	0	0
TOTAL MASSACHUSETTS AND NEW HAMPSHIRE	14	5	270	1	5	157	57	53	27	1

PREPARED BY STATISTICAL SECTION, RESEARCH DEPARTMENT, FEDERAL RESERVE BANK OF BOSTON

TABLE 6

SIZE DISTRIBUTION BY NUMBER OF INSTITUTIONS

AS OF DECEMBER 31, 1974

(BASED ON TOTAL ASSETS)

	ALL INSTITUTIONS			INSTITUTIONS OFFERING NOWS		
	< $50 M	$50-250 M	> $250 M	< $50M	$50-250 M	> $250 M
MASSACHUSETTS						
COMMERCIAL BANKS	101	41	11	21	23	7
MEMBERS	57	25	10	12	15	6
NON-MEMBERS	44	16	1	9	8	1
MUTUAL SAVINGS BANKS	69	84	14	43	74	14
SAVINGS & LOAN ASSOCIATIONS AND COOPERATIVES	156	22	1	51	18	1
FSLIC INSURED - MEMBERS FHLB	22	12	1	10	10	1
STATE INSURED - MEMBERS FHLB	25	3	0	7	4	0
STATE INSURED - NON-MEMBERS FHLB	109	7	0	34	4	0
TOTAL MASSACHUSETTS	326	147	26	115	115	22
NEW HAMPSHIRE						
COMMERCIAL BANKS	71	5	0	12	0	0
MUTUAL SAVINGS BANKS	22	11	1	9	10	1
SAVINGS & LOAN ASSOCIATIONS AND COOPERATIVES						
FSLIC INSURED - MEMBERS FHLB	16	2	0	10	1	0
STATE INSURED - MEMBERS FHLB	0	0	0	0	0	0
STATE INSURED - NON MEMBERS FHLB	0	0	0	0	0	0
TOTAL NEW HAMPSHIRE	109	18	1	31	11	1
TOTAL MASSACHUSETTS AND NEW HAMPSHIRE	435	165	27	146	126	23

PREPARED BY STATISTICAL SECTION, RESEARCH DEPARTMENT, FEDERAL RESERVE BANK OF BOSTON

TABLE 7

SOURCE OF NEW ACCOUNTS AND CHARGES PER DRAFT

AS OF DECEMBER 31, 1974

(DOLLAR AMOUNTS IN THOUSANDS OF DOLLARS)

	DEPOSITS TO NEW NOW ACCOUNTS FROM: (5)		CHARGES PER DRAFT			
	DEM DEPOSITS	TIME & SAV	FREE	$.10	$.15	OTHER (6)
MASSACHUSETTS						
COMMERCIAL BANKS	272	350	10	10	12	19
MEMBERS	132	272	6	6	8	13
NON-MEMBERS	140	78	4	4	4	6
MUTUAL SAVINGS BANKS	0	1,849	92	13	13	13
SAVINGS & LOAN ASSOCIATIONS AND COOPERATIVES	0	337	55	7	2	6
FSLIC INSURED - MEMBERS FHLB	0	178	15	4	0	2
STATE INSURED - MEMBERS FHLB	0	16	6	2	0	3
STATE INSURED - NON-MEMBERS FHLB	0	143	34	1	2	1
TOTAL MASSACHUSETTS	272	2,536	157	30	27	38
NEW HAMPSHIRE						
COMMERCIAL BANKS	215	39	6	0	6	0
MUTUAL SAVINGS BANKS	0	78	14	1	0	5
SAVINGS & LOAN ASSOCIATIONS AND COOPERATIVES						
FSLIC INSURED - MEMBERS FHLB	0	87	5	1	4	1
STATE INSURED - MEMBERS FHLB	0	0	0	0	0	0
STATE INSURED - NON MEMBERS FHLB	0	0	0	0	0	0
TOTAL NEW HAMPSHIRE	215	204	25	2	10	6
TOTAL MASSACHUSETTS AND NEW HAMPSHIRE	487	2,740	182	32	37	44

(5) THESE ARE TRANSFERS TO NEW NOW ACCOUNTS OPENED DURING THE MONTH FROM THE INSTITUTIONS OWN DEMAND DEPOSITS OR TIME AND SAVINGS DEPOSITS.

(6) "OTHER" INCLUDES INSTITUTIONS USING A COMBINATION OF FREE DRAFTS PLUS A CHARGE FOR EACH DRAFT OVER A SPECIFIED NUMBER.

PREPARED BY STATISTICAL SECTION, RESEARCH DEPARTMENT, FEDERAL RESERVE BANK OF BOSTON

Table 8

OUTSTANDING BALANCES - NEGOTIABLE ORDERS OF WITHDRAWAL (NOWs)

(in thousands of dollars)

MONTH ENDED	TOTAL OF ALL OFFERING INSTITUTIONS	COMMERCIAL BANKS					MUTUAL SAVINGS BANKS			SAVINGS & LOAN ASSOCIATIONS			
			MEMBER		NON-MEMBER						MASSACHUSETTS		
		TOTAL	MASS.	N.H.	MASS.	N.H.*	TOTAL	MASS.	N.H.	TOTAL	S&Ls	COOPS	N.H.
1972 Sept.	11,094						11,094	11,094					
Oct.	22,386						22,386	22,386					
Nov.	34,823						34,823	34,363	460				
Dec.	45,272						45,272	44,522	750				
1973 Jan.	60,726						60,726	59,661	1,065				
Feb.	73,451						73,451	71,975	1,476				
Mar.	86,118						86,118	84,162	1,956				
Apr.	94,606						94,606	92,341	2,265				
May	102,045						102,045	99,633	2,412				
June	108,381						108,381	105,688	2,693				
July	113,418						113,418	110,486	2,932				
Aug.	117,005						117,005	113,852	3,153				
Sept.	120,223						120,223	116,259	3,964				
Oct.	130,361						130,361	125,873	4,488				
Nov.	136,872						136,872	131,795	5,077				
Dec.	143,254						143,254	138,028	5,226				
1974 Jan.	143,190	2,556	1,511	--	763	282	139,779	134,832	4,947	855	470	385	--
Feb.	150,447	4,338	2,060	--	1,797	481	143,764	138,453	5,311	2,345	1,315	1,030	--
Mar.	165,157	6,588	2,882	--	3,034	672	154,007	147,845	6,162	4,562	2,340	1,985	237
Apr.	174,682	9,689	3,638	--	4,820	1,231	157,412	150,309	7,103	7,581	3,374	3,539	668
May	180,637	11,052	3,891	--	5,405	1,756	159,591	151,510	8,081	9,994	4,045	4,806	1,143
June	191,229	13,771	4,587	--	6,569	2,615	164,733	155,946	8,787	12,725	4,843	6,246	1,636
July	204,646	17,919	6,511	--	7,664	3,744	171,503	161,544	9,959	15,224	5,446	7,777	2,001
Aug.	232,386	32,955	13,707	--	14,743	4,505	180,335	169,119	11,216	19,096	7,313	9,468	2,315
Sept.	249,033	39,253	14,837	--	18,760	5,656	187,721	175,340	12,381	22,059	8,044	11,270	2,745
Oct.	270,813	46,776	18,969	--	21,276	6,531	197,758	184,830	12,928	26,279	9,978	13,338	2,963
Nov.	293,305	55,994	23,876	--	24,687	7,431	206,764	192,577	14,187	30,547	11,534	15,155	3,858
Dec.	312,576	65,249	28,964	--	28,025	8,260	213,661	200,083	13,578	33,666	13,206	16,541	3,919

Prepared by: Statistical Section, Research Department, Federal Reserve Bank of Boston
*Includes three member commercial banks.
The above adjustments were made to insure the confidentiality of individual institution data.

Table 9

NUMBER OF INSTITUTIONS OFFERING NEGOTIABLE ORDERS OF WITHDRAWAL (NOWs)

MONTH ENDED	TOTAL OF ALL OFFERING INSTITUTIONS	COMMERCIAL BANKS TOTAL	COMMERCIAL BANKS MEMBER MASS.	COMMERCIAL BANKS MEMBER N.H.	COMMERCIAL BANKS NON-MEMBER MASS.	COMMERCIAL BANKS NON-MEMBER N.H.*	MUTUAL SAVINGS BANKS TOTAL	MUTUAL SAVINGS BANKS MASS.	MUTUAL SAVINGS BANKS N.H.	SAVINGS & LOAN ASSOCIATIONS TOTAL	SAVINGS & LOAN ASSOCIATIONS MASS. S&Ls	SAVINGS & LOAN ASSOCIATIONS MASS. COOPS	SAVINGS & LOAN ASSOCIATIONS N.H.
1972 Sept.	23						23	23	--				
Oct.	35						35	35	--				
Nov.	52						52	46	6				
Dec.	59						59	50	9				
1973 Jan.	63						63	53	10				
Feb.	67						67	55	12				
Mar.	69						69	57	12				
Apr.	69						69	57	12				
May	69						69	57	12				
June	69						69	57	12				
July	70						70	58	12				
Aug.	72						72	60	12				
Sept.	74						74	61	13				
Oct.	80						80	66	14				
Nov.	86						86	71	15				
Dec.	90						90	75	15				
1974 Jan.	126	14	5	1	6	2	100	85	15	12	4	7	1
Feb.	141	15	5	1	7	2	104	89	15	22	6	15	1
Mar.	171	21	8	3	8	2	114	98	16	36	9	23	4
Apr.	188	24	9	3	10	2	121	104	17	43	12	27	4
May	204	26	9	4	11	2	126	108	18	52	12	35	5
June	227	35	14	7	12	2	133	114	19	59	15	38	6
July	238	37	15	8	12	2	137	118	19	64	17	39	8
Aug.	248	41	18	8	13	2	140	120	20	67	18	41	8
Sept.	257	42	18	9	13	2	142	122	20	73	20	45	8
Oct.	277	53	28	9	14	2	148	128	20	76	20	46	10
Nov.	285	58	31	9	16	2	148	128	20	79	21	48	10
Dec.	295	63	33	9	18	3	151	131	20	81	21	49	11

Prepared by: Statistical Section, Research Department, Federal Reserve Bank of Boston

MR. RIPPEY

#7

FOR INFORMATION PRIOR TO CONSIDERATION AT A BOARD MEETING

February 4, 1975

To: Board of Governors

From: Legal Division (Messrs. Raiken and Schwartz)

Subject: Summary of Comments on the Board's proposed amendment to prohibit governmental NOW accounts.

ACTION REQUESTED: None at this time. This memorandum is a summary of the comments received in response to the Board's publication of a proposed amendment to Regulation Q to prohibit member banks from continuing to offer governmental NOW accounts.

BACKGROUND: On November 26, 1974 the Board (and the FDIC) amended Regulation Q to permit member banks to offer savings accounts to governmental units. That action also had the effect of permitting governmental units in Massachusetts and New Hampshire to obtain NOW accounts. After reviewing requests from the ABA, the Massachusetts Bankers Association and Senator McIntyre, the Board and the FDIC agreed to reconsider that part of the amendment which permitted governmental units to hold NOW accounts.

COMMENTS RECEIVED: The comment period expired on January 20, 1975. Approximately 145 comments have been received on the subject proposal as of January 29, 1975. Comments were received from four groups: (1) commercial banks throughout the United States; (2) bankers associations; (3) Federal Reserve Banks and (4) other interested parties including governmental treasurers, Congressmen, and the Public Interest Research Group.

These groups expressed the following positions:

	Number of Respondents	Favor Proposal	Against Proposal
I. Commercial Banks	124	120	4
II. Bankers Associations	10	7	3
III. Federal Reserve Banks	6	4	2
IV. Others	6	1	5
TOTAL	146	132	14

Attachment A presents the major comments received and the number of times mentioned by members of the above groups.

I. Commercial Banks

Of 124 banks commenting on the proposal, 120 were in favor of the Board prohibiting governmental NOW accounts and 4 were opposed. Most of the comments (77) came from the First Federal Reserve District, which includes the States of Massachusetts and New Hampshire. all 77 banks were in favor of prohibiting governmental NOWs.

The most frequently cited reason by banks for their position was that governmental NOWs would result in commercial banks losing a substantial amount of governmental deposits to thrifts. The resulting loss would affect bank liquidity and result in a depression of bank earnings. This comment was mentioned by 73 banks.

Fifty-seven banks stated that it was their belief that the NOW experiment was originally authorized solely for individuals.

Forty-nine banks noted that governmental NOWs would result in a lessening in the support they provide to the governmental securities markets, with the result that governments will incur an increase in the interest rates they must pay on such obligations. Many of these respondents stated that they would also eliminate many banking services they now provide without charge to governmental bodies.

Ten respondents mentioned that it would be improper to authorize NOWs in light of the severe economic hardship which the Northeast is undergoing at present.

Nine banks cited their belief that governmental NOW deposits would not result in an increase in mortgage funds because governmental NOW funds would be essentially transactional in nature.

Those banks in favor of governmental NOWs (4) expressed their belief that NOW accounts would assist public treasurers in obtaining a higher return on their money and that governmental NOWs are a logical extension to the basic NOW experiment.[1/]

II. Banker's Associations

Ten bankers associations commented on the proposal. Those organizations representing commercial banks were in favor of the proposed amendment to prohibit governmental NOWs. These groups included:

- American Bankers Association
- Long Island Bankers Association
- Massachusetts Bankers Association
- New Hampshire Bankers Association
- New York State Bankers Association
- Massachusetts Independent Bankers Association
- Pennsylvania Bankers Association

1/ First National City Bank; Peoples Trust of New Jersey; Iowa-Des Moines National Bank; First National Bank of Clayton, Missouri.

These associations stressed their belief that Congress intended NOWs to be available solely to individuals and that governmental NOWs would adversely affect bank liquidity. The Massachusetts Bankers Association ("MBA") was particularly vocal, having submitted a 25 page comment. The MBA contends that it was the intent of Congress that NOWs be made available to individuals, not corporations or governmental bodies. They also cite the adverse competitive effect governmental NOWs would have upon commercial banks, especially in light of the severe economic hardships which the northeastern U.S. is undergoing at present.

The National Association of Mutual Savings Banks, the Savings Bank Association of Massachusetts and the Massachusetts Co-operative Bank League oppose the proposed amendment, and express the belief that governmental NOWs would aid the investment programs of government treasurers, stimulate competition for public funds among the various financial institutions, and would serve the public interest by providing additional interest revenue to governments.

III. Federal Reserve Banks

Comments in favor of the amendment to prohibit governmental NOW accounts were received from the Atlanta, Dallas, Philadelphia and Richmond Reserve Banks. These banks believe that NOW accounts are intended to be solely for individuals.

Two of these Reserve Banks also expressed their belief that governmental NOWs would adversely affect bank liquidity.

The New York Reserve Bank is opposed to the adoption of the amendment, contending that extension of the experiment would provide useful data for analysis purposes as well as stimulate competition for governmental deposits. The Chicago Reserve Bank also opposes the amendment, stating that governmental NOWs would, after consideration of the negative and positive effects, be in the public interest.

IV. Other Respondents

Senators McIntyre and Proxmire have commented on the concept of governmental NOW accounts. Senator McIntyre stated his belief that NOWs were never intended to be available to ~~individuals~~ governments, while Senator Proxmire opposed the amendment, stating that the extension of the NOW experiment to governmental deposits would have a number of significant or beneficial results, not the least of which would be increased interest earned by governmental bodies. Senator Proxmire sees nothing in the law to prohibit governmental NOWs.

The Treasurers of the States of Illinois and Iowa as well as the Treasurer of the City of Rockford, Illinois expressed opposition to the proposed amendment, contending that governmental NOWs would aid governmental investment programs.

Other comments opposing the proposed amendment were received from the Public Interest Research Group which, although in favor of governmental NOWs, alleged that the Board may not adopt the proposed amendment because the original amendments authorizing governmental savings accounts were adopted in violation of the public notice requirements of the Administrative Procedure Act.

Attachment

ATTACHMENT A

COMMENTS BY RESPONDENTS
(Number of times mentioned)

	Commercial Banks	Bankers Associations	Federal Reserve Banks	Others
1. NOW account experiment was originally authorized by Congress to be offered exclusively to individuals.	57	5	2	1
2. If governmental NOW accounts are authorized, commercial banks may incur a substantial loss of governmental deposits to thrifts, thereby adversely affecting bank liquidity and resulting in a depression of bank earnings.	73	3	2	-
3. Loss of governmental deposits by banks will result in decreased bank participation in governmental securities markets, increases in rates of interest governments must pay, elimination of free banking services being offered to governments, and increased service charges and loan rates to other bank customers.	49	2	-	-
4. Governmental NOW account balances will be transactional in nature and are maintained for too short a period of time to be invested in long-term mortgages.	9	-	-	-
5. Expansion of NOWs to governmental units is unwise in light of severe economic hardships which NEUS is undergoing at present.	10	1	-	-
6. Governmental NOWs will assist the investment programs of public treasurers and are a logical extension to the NOW experiment.	3	3	1	5

Return this copy to
Legal Division as soon
as original is mailed
showing on copy the date
of mailing.

#808

DEC 27 1974

The Honorable Thomas J. McIntyre
United States Senate
Washington, D. C. 20510

Dear Senator McIntyre:

Thank you for your letter of December 20, 1974, in which you urge the Board to modify its regulations on governmental unit savings deposits to continue to prohibit member banks from offering NOW accounts to such entities. The Board and the FDIC have received several requests that their respective regulations be modified in the manner you recommend.

As a result of receipt of these comments, the Board has agreed to reconsider this matter. On December 23, 1974, the Board issued the enclosed press release and Federal Register notice soliciting public comments until January 20, 1975, on the question of whether member banks should continue to be able to offer NOWs to governmental units. The Board's announcement also advises that until a final determination is made by the Board, member banks should not offer NOW accounts to governmental units.

The Board would welcome any further comments you might have on this matter.

Sincerely,

(Signed) George W. Mitchell

George W. Mitchell

Enclosures

ALR:iks
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United States Senate

COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS
WASHINGTON, D.C. 20510

December 20, 1974

#808

DEC 20 1974

The Honorable George Mitchell
Vice Chairman
Board of Governors
Federal Reserve System
20th and Constitution Avenue Northwest
Washington, D. C. 20551

Dear Governor Mitchell:

It has come to my attention that the Federal Reserve and the other financial regulatory agencies are contemplating permitting the acceptance of public unit deposits in the form of NOW accounts by commercial banks and thrift institutions in the States of Massachusetts and New Hampshire. This development arises from efforts to implement Section 101 of the "Depository Institutions Amendments of 1974", Public Law 93-495. I believe that this development is unwarranted and that regulations should continue to insure that NOW accounts are confined to individuals and non-profit corporations.

The legislative history is clear that Congress' intent was to limit NOW accounts to individuals. These are family financial accounts. While their ownership by non-profit groups is deemed to be a permissible extension of this purpose, there is no mention of authorizing NOW accounts for governmental entities or public units, and, in fact, Congress' intent was exactly to the contrary. Moreover, nothing in the legislative history surrounding Public Law 93-495 alters this result.

Congress labored long and hard during the NOW account controversy, and finally adopted a compromise providing for the experimental use of NOW accounts in the States of Massachusetts and New Hampshire. In both the Committee report and debate on the Senate floor, it was made clear that NOW accounts were intended to benefit consumers; and therefore, they should be limited solely to individuals. In the Committee report itself, the following language appears: "The Committee, however, is convinced that such accounts should only be offered and limited solely to individual persons." This position was maintained throughout Congress' consideration of this legislation; and the action contemplated by your agency and the other bank regulatory agencies in expanding the NOW account service to governmental entities is directly contrary to the stated purpose of the legislation.

It should be noted that this issue arose earlier this year when the Federal Home Loan Bank Board sought to allow savings and loan associations in Massachusetts and New Hampshire to accept NOW deposits from governmental entities. At that time, I raised similar objections, and the Board subsequently modified its regulations to prohibit the acceptance of NOW accounts from governmental bodies by such savings and loan associations.

I urge you to conform your regulations on public unit savings accounts to continue the prohibition on the acceptance of NOW deposits from governmental entities by commercial banks and thrift institutions in Massachusetts and New Hampshire. The concept of permitting public unit depositors to have NOW accounts should be given serious consideration at the appropriate time. Such accounts may very well be in the public interest. However, since NOW accounts are still in an experimental stage, that experiment should be left as it is until an overall policy on NOW accounts is established. Just such a policy is contained, for example, in the Financial Institutions Act. Therefore, it would be inappropriate for the regulatory agencies to broaden the base of NOW accounts in this manner at this time.

Your prompt attention to this matter will be appreciated greatly, and I hope to have a response from you at your earliest convenience.

Sincerely,

Thomas J. McIntyre

Thomas J. McIntyre, U.S.S.
Chairman
Subcommittee on Financial
Institutions

FEDERAL RESERVE

press release

For Immediate Release

October 17, 1974

The Board of Governors of the Federal Reserve System today removed the 150-item limitation on the number of Negotiable Orders of Withdrawal (NOWS) that may be accepted by a member bank in Massachusetts and New Hampshire in any one year.

A copy of the Board's order in this matter is attached.

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TITLE 12--BANKS AND BANKING

CHAPTER II--FEDERAL RESERVE SYSTEM

[REG. Q]

PART 217--INTEREST ON DEPOSITS

Negotiable Orders of Withdrawal

Effective January 1, 1974, the Board of Governors amended Regulation Q (Interest on Deposits) to prescribe rules governing the use of Negotiable Orders of Withdrawal (NOWs) within Massachusetts and New Hampshire as authorized by section 2(a) of P.L. 93-100. These rules include a limitation on the number of NOWs that may be accepted by a member bank from a customer to 150 per year. NOW accounts in other institutions have not been made subject to an item limitation.

Since the adoption of NOW account amendments to Regulation Q, the Board of Governors and the other Federal financial supervisory agencies have conducted a surveillance program designed to monitor NOW account activity. Data received for the first eight months of NOW activity in Massachusetts and New Hampshire since Federal regulations were adopted indicate that NOW account activity has developed in a gradual manner without the wholesale conversion of checking accounts to NOW accounts. On the basis of its evaluation of current NOW account data and pursuant to P.L. 93-100 and the Board's authority under section 19 of the Federal Reserve Act to prescribe rules governing the payment of interest on deposits, the Board has amended Regulation Q to remove the 150 per year limitation on the number of NOWs that may be accepted from a customer by a member bank. As a result of this action, member banks and NOW depositors will be permitted to amend existing NOW account deposit agreements to remove item limitation provisions.

There was no notice, public participation and deferred effective date with respect to this amendment because such procedure would result in delay that would be contrary to the public interest and serve no useful purpose. See § 262.2(e) of the Board's Rules of Procedure (12 CFR § 262.2(e)).

Effective immediately, the Board has amended section 217.5(c) of its Regulation Q (12 CFR Part 217) to read as follows:

§ 217.5 Withdrawal of Savings Deposits

*   *   *   *   *

(c) Manner of payment of savings deposits

(1) Subject to the provisions of subparagraphs (2) and (3) of this paragraph, * * *

*   *   *   *   *

(3) The provisions of this paragraph do not apply to deposits subject to negotiable orders of withdrawal authorized by Federal law to be issued in the states of Massachusetts and New Hampshire.

(4)   *   *   *   *

By Order of the Board of Governors, October 17, 1974.

(Signed) Theodore E. Allison

Theodore E. Allison
Secretary of the Board

[SEAL]

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

Office Correspondence

Date October 8, 1974

To Board of Governors

Subject: NOW accounts data for August 1974

From Banking Section
(Paul W. Boltz)

This memorandum is for information only and concerns developments in NOW accounts in New Hampshire and Massachusetts in August 1974.

Inflows to NOW accounts at member banks were up sharply in August, principally due to a single bank's transferring a block of its savings accounts to NOW status. The Third National Bank of Hampden County, Springfield, Massachusetts, began offering NOW accounts by notifying the holders of over 4,000 savings accounts representing deposits of $6.3 million that they could write NOW drafts on their accounts. The bank is one of 10 weekly reporting banks in Massachusetts and has total deposits of over $200 million. The Boston Federal Reserve is investigating the unorthodox method of introducing NOW accounts by the Third National Bank, but there appears to be nothing illegal in the procedure and other banks may follow.

Another large member began offering NOW's on October 1 and initiated a heavy statewide advertising campaign in Massachusetts. The Shawmut Association with nine banks (total deposits $1.7 billion) is promoting its new NOW accounts as part of a marketing strategy that includes a package of services of free checking, free checks, and over-draft privileges for a flat monthly fee. This is the first time a commercial bank has advertised NOW accounts statewide in either New Hampshire or Massachusetts. In contrast, the largest banking organization in Massachusetts, First National Bank of Boston, has been advertising locally <u>against</u> NOW accounts.

With the sharp growth of NOW balances associated with the Third National Bank of Hampden County, NOW balances at member banks in Massachusetts more than doubled during August, given their small initial size. However, the growth of NOW deposits at MSB's in Massachusetts still nearly equaled the expansion of balances at commercial banks. The 10 percent rate of growth of NOW balances at all institutions in the two states in August was the highest of the year. Three commercial banks, three MSB's and three S&L's began offering NOW accounts in New Hampshire and Massachusetts in August, and by the end of the month 70 percent of the MSB's were offering NOW accounts, while the proportion for S&L's was 34 percent and for banks 18 percent.

NOW accounts at commercial banks continue to be significantly larger than accounts at competing institutions, and their activity appears to be declining relative to the activity of accounts at thrift institutions. In August, the average number of drafts per NOW account at commercial banks was likely lowered by the sudden creation of such accounts at the Hampden County bank for depositors unfamiliar with the account, but a declining average level of activity of NOW accounts at commercial banks has been observed since May. The 150 item limitation may be responsible for the lower level of drafts, but this has not been confirmed by available data. At other institutions in Massachusetts, the MSB's accounts have had a relatively stable level of activity, but the S&L's NOW accounts have become progressively more active and in August were the most active accounts. In New Hampshire, the NOW accounts at the MSB's had the highest average number of drafts, followed by the accounts at S&L's and banks.

There has developed a noticable and predictable relationship between level of activity of accounts at the competing institutions and the proportion of such institutions offering free draft privileges. In the two states, the highest level of activity is found in NOW accounts at MSB's in New Hampshire, three-quarters of which offer free drafts; at the other end of the scale, the lowest level of activity is found at commercial banks in Massachusetts where only 17 percent of the banks offer free drafts.

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BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

Office Correspondence

Date September 6, 1974

To Board of Governors

Subject: NOW account data for July 1974

From Banking Section (Paul W. Boltz)

This memorandum is for information only and concerns developments in NOW accounts in New Hampshire and Massachusetts in July 1974.

Net inflows into NOW accounts at all offering institutions continue at a rapid pace in the two states. Deposits in NOW accounts at commercial banks increased 30 per cent in July, although only two more commercial banks began offering NOW accounts for the first time during the month, and NOW deposits at savings and loan associations expanded by 20 per cent, as 5 additional S&L's began offering such accounts during July. The NOW balances at mutual savings banks grew at the lower rate of 7 per cent in July, but in spite of the competition from banks and S&L's, NOW balances at MSB's accounted for almost 84 per cent of all NOW balances in the two states in July, seven months after competing institutions were allowed to offer NOW accounts. In fact, since January 1 of this year, more mutual savings banks have begun offering NOW's than commercial banks (47 versus 37), and at the end of July almost 70 per cent of all mutual savings banks were offering NOW accounts. The fastest spread of the NOW accounts, however, has been at the S&L's in 1974. At the end of July, 64 S&L's--almost one-third of all the S&L's in the two states--were offering NOW accounts. Nonbank financial institutions are moving much more quickly into NOW accounts than commercial banks. (Tables 1 and 9)

In July, commercial banks offering NOW accounts were more successful in attracting new customers through NOW accounts. Almost 60 per cent of NOW accounts opened at commercial banks during the month were opened by new customers. In recent months, the proportion of new customers opening accounts had tended toward about 45 per cent at all types of NOW-offering institutions, and in July the proportion of new customers opening NOW accounts at S&L's was slightly higher than this, and at MSB's was slightly lower. (Table 2)

Member bank NOW accounts continue to be larger and less actively used than NOW accounts at competing institutions, including nonmember commercial banks. And although member bank NOW accounts are gradually becoming more active, the differential between the average balance in member bank NOW accounts and other NOW accounts widened in July. Commercial banks, member and nonmembers alike, encourage the use of their NOW accounts as savings accounts by placing charges on drafts and paying the ceiling rate on the deposits. While well over one-third of the S&L's and MSB's that offer NOW accounts have free draft privileges, at the end of July only 16 per cent of commercial banks offering NOW's provided free drafts. Moreover, a majority of banks compound interest on NOW accounts monthly or quarterly, rather than continuously or daily as most competing institutions do. One-fourth of the NOW-offering member banks do not pay interest from day of deposit to day of withdrawal while only 5 per cent of competing instititions pay interest in a way other than from day of deposit to day of withdrawal. Thus, the commercial banks have been slow to offer NOW accounts and, when offered, have tended to adopt a combination of charges on drafts and interest calculations that induce the use of NOW accounts as a savings accounts. (Tables 3A, 3B, 4A, 4B, and 5)

Over 90 per cent of all NOW-offering institutions pay the ceiling rate of 5 per cent. The major exceptions are the mutual savings banks in New Hampshire which have a history of low interest rates with no charges for drafts. Almost 70 per cent of them pay at or below 4 per cent on NOW balances.

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BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

Office Correspondence

Date July 15, 1974

To Board of Governors

Subject: NOW Account data for May

From Banking Section (Paul W. Boltz)

This memorandum is for information only and summarizes developments in NOW accounts in New Hampshire and Massachusetts during May 1974.

--Savings and loan associations continue to move aggressively into offering NOW accounts. S&L's accounted for 9 of the sixteen institutions which began offering NOW accounts in May, along with 2 commercial banks and 5 mutual savings banks. At the end of May more than a quarter of the S&L's were offering NOW accounts in the two states, while less than one out of eight commercial banks were offering NOW's. Relatively few member banks have begun to offer NOW's; at the end of May only 13 out of the 143 member banks in the two states were offering such accounts. Thus, the 63 per cent of mutual savings banks that offer NOW's continue to hold the large majority of NOW deposits--88 per cent of the total. (Tables 1 and 8)

--Outstanding balances of NOW accounts grew 3.4 per cent in May, the slowest rate since January. However, the not seasonally adjusted annual rate of growth of NOW account balances at all institutions in the first five months of 1974 was almost 50 per cent. Though the MSB's did not maintain the extremely rapid pace of growth of 1973 (over 300 per cent), in the first five months of 1974 their NOW balances grew at a not seasonally adjusted annual rate of 27 per cent. (Table 8)

--Commercial banks were more successful than MSB's or S&L's in attracting new customers to their NOW accounts. Less than half the new accounts in May at S&L's and MSB's were opened by new customers, while almost 60 per cent of accounts opened at commercial banks in May were opened by new customers. (Table 2)

--The level of activity of NOW accounts at member commercial banks is far less than activity at other institutions, including nonmember commercial banks. Over 70 per cent of NOW accounts at member banks in Massachusetts had no drafts written on them in May. At all other NOW-offering institutions in Massachusetts, the proportion was less than 30 per cent. Also, the balances in accounts at member banks are considerably larger than balances in accounts at competing institutions, and thus the NOW accounts at member banks appear to be used as savings accounts, rather than as demand deposits. The sharpest contrast to this are the NOW accounts at mutual savings banks in New Hampshire where the balances are on average less than half the balances at member banks in Masachusetts and the level of activity makes the accounts appear to be checking accounts. These institutions offer low rate, no service charge NOW accounts. (Tables 3A and 3B)

--The proportion of institutions offering free draft privileges on NOW accounts has been gradually increasing, and most of the increase has been due to more MSB's offering free drafts. Since January, the proportion of S&L's and commercial banks offering free draft privileges has been relatively volatile, but as the number of S&L's and CB's offering NOW's becomes larger, the trend will become clearer and not so easily affected by small changes at the margin. By the end of May, 55 per cent of NOW-offering institutions in New Hampshire were offering free drafts and 32 per cent in Massachusetts.

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

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Office Correspondence

Date June 5, 1974

To Board of Governors

Subject: NOW Account data for April

From Banking Section (Paul W. Boltz)

This memorandum is for information only and summarizes developments in NOW accounts in New Hampshire and Massachusetts during April 1974.

-- In April, 17 more institutions began offering NOW accounts in New Hampshire and Massachusetts--3 commercial banks, 7 mutual savings banks, and 7 savings and loan associations. Savings and loan associations have moved very quickly into offering NOW accounts. Although there are fewer S&L's than either CB's or MSB's, the number of S&L's which began offering NOW accounts since the end of January equals the number of CB's and MSB's combined which began offering NOW's in the same period. At the end of April, more than 20 per cent of S&L's was offering NOW's in the two states, compared to about 10 per cent of the commercial banks. Mutual savings banks continue to dominate the field with 60 per cent of them offering NOW accounts and holding 90 per cent of total NOW deposits. (Tables 1 and 8)

-- NOW balances at all institutions in the two states grew 5.8 per cent in April, with more than half the growth occurring at CB's and S&L's. Except for an unexplained spurt of growth in March, NOW accounts at MSB's have been growing at depressed rates since commercial banks and S&L's began offering NOW accounts in January 1974. (Table 8)

-- About 45 per cent of NOW accounts opened in April were opened by new customers at commercial banks and mutual savings banks. S&L's did not attract as many new customers, as only 35 per cent of their new accounts were opened by new customers. Approximately 20 per cent of the initial NOW deposits at commercial banks made by existing customers were from time and savings deposits. (Tables 2 and 7)

-- NOW accounts at commercial banks continued to be less actively used on average than NOW accounts at competing institutions. Commercial banks have a relatively large proportion of accounts that have no activity, but the average number of drafts of accounts at commercial banks that have any activity is rising. In Massachusetts, the average approached the level of activity of comparable accounts at MSB's in April. The same is true of the NOW accounts at S&L's in Massachusetts, which like the commercial banks have a large proportion of completely inactive accounts. On the other hand, in New Hampshire the NOW accounts at S&L's and commercial banks with any activity are less active by a good margin than NOW accounts at the MSB's. (Tables 3A and 3B)

most 1-20 per month

-- Almost all institutions offering NOW accounts in Massachusetts were paying the ceiling rate of 5 per cent, and all the banks and S&L's in New Hampshire were paying the ceiling rate in April. But only 2 of the 17 mutual savings banks in New Hampshire offering NOW accounts were at this rate, and the others were paying 4 per cent or below. The majority of institutions were paying interest from day of deposit to day of withdrawal. (Tables 4A and 4B)

-- In April the number of CB's offering free drafts did not change, but two MSB's and two S&L's began offering free drafts. Thus, while 17 instituitions began offering NOW accounts in April, only 4 additional institutions provided free draft privileges. Of all institutions offering NOW accounts, the proportion with free drafts at the end of April was 34 per cent. The trend is uncertain in this regard, however, since the proportion of NOW-offering institutions with free draft privileges had risen noticeably in the previous month. (Table 10)

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

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Office Correspondence

Date May 29, 1974.

To Board of Governors

From Frederic Solomon FS

Subject: Spread of NOW-type Accounts.

For Information Only

There appears to be a growing tendency for NOW-type accounts to spread to areas beyond New England.

The attached clipping from the New York Times of Monday, May 27, describes such accounts being offered by certain mutual savings banks in New York. One of these mutual savings banks called its accounts WOW accounts, standing for "Written Order of Withdrawal."

Mr. Piderit, Vice President of the Federal Reserve Bank of New York, indicated that these accounts are offered under a long neglected provision of law and that the State Banking Department has no plans to discourage them.

Also attached is a copy of an advertisement forwarded by Senior Vice President Morrison of the Chicago Reserve Bank. This advertisement, issued by First Federal Savings and Loan Association of Wisconsin, offers what it calls a "telephone savings account," which pays 5-1/4% interest compounded daily. The S&L has established procedures by which the customer can telephone at any time and have funds transferred to his bank to meet checks which he has drawn. While the approach is not new, it might have increased appeal at the present time and could be available to anyone, including corporations.

FIRST FEDERAL
SAVINGS
OF WISCONSIN

FIRST FEDERAL SAVINGS AND LOAN ASSOCIATION OF WISCONSIN

Manitowoc Office
CORNER OF NORTH 8TH & YORK STREETS
MANITOWOC WISCONSIN 54220
TELEPHONE (414) 682 6812

May 8, 1974

Wisconsin Aluminum Foundry Co., Inc.
836 So. 16th St.
Manitowoc, Wisconsin

Sent to all IPC's

Dear Mr. Schwartz:

We would like to introduce you to a new plan offered by First Federal Savings and Loan of Wisconsin for corporations, small businesses, and the self-employed. It's called our "Telephone Savings Account."

It was designed with several objectives in mind:

To provide a temporary and liquid short term investment for cash balances which earn no interest in checking accounts.

To provide with this service, the convenience of handling your transactions by telephone.

The Telephone Savings Account will pay 5¼% interest, compounded daily on all funds, from the date of deposit to the date of withdrawal. Deposits may be made by simply drawing a check payable to First Federal Savings and Loan, for credit to the account of ______(name)______, ____(account number)____, and mailing it to First Federal Savings and Loan, 724 - York Street, Manitowoc, Wisconsin.

When you need funds to cover checks drawn on your checking account, call the First Federal "Telephone Savings Account Teller" any time between 10:00 A.M. and 3:00 P.M., at 682 - 6812 and give her the following information:

Your Name (Authorized Person)	Account Number
Name of Firm	Amount of Withdrawal

A check for the withdrawal will be personally delivered to your bank the following morning. The monthly statement furnished will itemize each transaction and state current balance of your account following posting of all transactions for the month.

We welcome an opportunity to further discuss with you interest dollars you can earn with our Telephone Savings Account.

Very truly yours,

FIRST FEDERAL SAVINGS AND LOAN ASSOCIATION
of WISCONSIN

Beatrice E. Klein

Beatrice E. Klein,
Branch Manager

Enc:

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BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

Office Correspondence

Date April 30, 1974

To Board of Governors

Subject: NOW Account data for March

From Banking Section (Paul Boltz)

This memorandum is for information only and summarizes the major developments regarding NOW accounts in March 1974.

-- During March, 30 additional institutions began offering NOW accounts in Massachusetts and New Hampshire (6 commercial banks, 10 mutual savings banks, and 14 saving and loan associations). By the end of the month, 9.2 per cent of the commercial banks, 18.7 per cent of the savings and loan associations, and 56.7 per cent of the mutual savings banks were offering NOW's (Table 1).

-- NOW balances at all institutions increased 9.7 per cent in March and reached $165.2 million. Of that total only 4 per cent were deposits at commercial banks and 2.8 per cent were deposits at S & L's, but deposits at these institutions are growing very rapidly in percentage terms (Tables 1 and 8).

-- The increase of NOW account balances at mutual savings banks in the first quarter of 1974 was sharply below the average quarterly increases in 1973. However, the total quarterly increase of NOW accounts balances at all offering institutions was almost as high as the 1973 average. The first quarter rise in NOW balances at all institutions was $21.9 million, of which $10.8 million was the mutual savings banks' share of the increase. The average quarterly increase of NOW balances in 1973, when only MSB's offered NOW's, was $24.5 billion. While part of this reduced rate of growth at MSB's can be attributed to one-time portfolio adjustments which were occurring during the early part of 1973, part should also be attributed to the introduction of competition from other depository institutions.

-- Slightly more than 40 per cent of the NOW accounts opened at commercial banks in March were opened by existing customers. About 55 per cent of the initial deposits in NOW accounts were from time and savings deposits, up sharply from January and February when less than one-third of new deposits by existing customers were from time and savings deposits (Tables 2 and 7).

-- Commercial bank NOW balances continued to be both larger and less actively used than NOW accounts at competiting institutions (Tables 3A and 3B). The average NOW account balance in March at commercial banks was $1786 ($2008 for members and $1623 for nonmembers), far higher than the average of $1295 at MSB's and the average balance of $852 at S&L's. The accounts at both S&L's and commercial banks are becoming more active as each month passes, but slightly less than half (46.6 per cent) of NOW accounts at commercial banks had no activity in March, with most of the inactive accounts at member banks. In contrast, only 26 per cent of NOW accounts at MSB's and 36 per cent of NOW accounts at S&L's had no activity. The most active accounts are those at mutual savings banks in New Hampshire; 19 per cent of these had more than 20 drafts written on them in March.

-- As in earlier months, virtually all NOW-offering institutions in Massachusetts were paying the ceiling rate of 5 per cent (Tables 4A and 4B). In New Hampshire, however, while all commercial banks and S&L's were at the ceiling rate only 2 of the 16 mutual savings banks ofeering NOW's were at that rate, and the others were paying 4 per cent or below. The majority of institutions are paying interest from day of deposit to day of withdrawal (Table 5).

-- About one-third of the MSB's and S&L's in Massachusetts offering NOW accounts provide unlimited free draft privileges to depositors. This proportion is up from January and may reflect competition to attract depositors. The large majority of MSB's in New Hampshire (81.3 per cent) also offer free drafts, and this high proportion may account for the considerable activity reported for these accounts. Less than 15 per cent of the banks offering NOW's in the two states offer free drafts (Table 10).

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approved w/ changes
5/1/74

April 29, 1974

To: Board of Governors

From: Legal Division
(Messrs. Nicoll
and Raiken)

Subject: Request by First National Bank of Boston to suspend Regulation Q limitations on transfers from savings accounts.

BANK REQUEST: The First National Bank of Boston ("Bank") has requested that the Board suspend operation of section 217.5(c)(2)(i) of Regulation Q in the States of Massachusetts and New Hampshire in conjunction with the operation of the NOW account experiment currently underway in those States.[1/] This paragraph prohibits withdrawals from savings deposits through payment to the bank or transfer of credit to another deposit account of the same depositor made pursuant to an advertised plan or agreement authorizing such payments as a normal practice to cover the depositor's drafts or checks.

RECOMMENDED ACTION: It is recommended that the requested suspension of the savings deposit transfer limitations be denied for the reasons summarized as follows:

1. A question exists as to the Board's legal authority to suspend (or amend) the present transfer limitations as to non-NOW accounts only in Massachusetts and New Hampshire.

2. Removal of the transfer limitations would permit use of savings deposits to cover drafts drawn on token checking accounts and thereby, for all practical purposes, result in the payment of interest on demand deposits.

1/ A copy of Bank's request is attached as Attachment A. President Morris of the Federal Reserve Bank of Boston by letter of April 22 recommends approval of the requested suspension (Attachment B). The General Counsel of the Boston Reserve Bank recommends denial of Bank's request (Attachment C).

3. Removal of the transfer limitations would result in a major change in the character of savings deposits in Massachusetts and New Hampshire and thereby alter the environment in which Congress authorized a limited experiment to be conducted.

4. Bank presently has the ability to offer NOWs to its customers and has not presented any evidence supporting its contention that the Board's 150 item limitation is seriously inhibiting its ability to market NOWs.

Arguments in favor of Bank's proposal may be summarized as follows:

1. The suspension action may be taken as part of the NOW experiment authorized by Congress and therefore would be legally sustainable under the Board's authority to issue regulations for NOW accounts.

2. The suspension of transfer limitations will do no more to permit the payment of interest on demand deposits than the present NOW account as sanctioned by Congress.

3. Removal of transfer limitations will permit member banks to offer a comparable alternative to NOW accounts, but one which does not require the creation of an additional account and does not result in additional items entering the payments mechanism.

COORDINATING COMMITTEE CONSIDERATION: At a recent meeting of the Interagency Coordinating Committee, Governor Mitchell informed the representatives of the other agencies that the subject request had been received and would be considered by the Board in the near future. No objections were expressed regarding Bank's request by members of the Coordinating Committee. Chairman Bomar of the FHLBB expressed the view that since Bank is apparently attempting to develop a means to offer services similar to NOWs but without the Board's 150 item limitation, if the Board is inclined to grant relief, such action should more appropriately take the form of a removal or modification of the item limitation itself. It was also confirmed at this meeting that the FDIC, without formal announcement, has for more than a year permitted withdrawals or transfers from a savings deposit to a depositor or to another account of the same depositor by means of telephone requests.[2/]

DISCUSSION: Bank states that suspension of the transfer limitations would (1) enhance deposit experiments currently in progress regarding NOW accounts and automatic withdrawals from S&L savings deposits[3/] and (2) enable commercial banks to compete on a more equal basis with thrift institutions which offer NOW accounts.

The requested action appears related to the effect of the 150 item limitation contained in the Board's NOW account regulations. In its advertising copy (Attachment B) the Bank has stressed the concept of an account for saving and an account for spending. The proposed arrangement would enable it to offer both types of accounts with a link to cover overdrafts or excessive balances in the "spending" account.

2/ A memorandum from the Legal Division recommending reconsideration of the Board's 1936 interpretation against telephone transfers will be presented to the Board within the next few weeks.

3/ The FHLBB has authorized a cash dispensing deposit-withdrawal "POS" pilot project to be conducted in Lincoln, Nehraska. In addition, FHLBB regulations permit preauthorized payments to third parties from savings accounts to (1) purchase U.S. obligations, (2) purchase mortgagor or savings member insurance, (3) transfer funds to a relative of the depositor, (4) purchase a housing or housing-related item, pay loans for such items, including real estate mortgages, taxes and insurance, rent, utilities, home improvements, fixtures, home furnishings or major appliances and similar items (12 C.F.R. 545.4(2)).

<u>Origin of Present Transfer Limitations</u>: The present savings deposit transfer limitations that Bank requests be suspended were adopted in January 1962 primarily in view of the practice developed by Citizens Bank and Trust Company of Park Ridge Illinois, whereby that bank permitted a depositor maintaining a savings account to draw checks against the bank. Under the agreement between the bank and the depositor, checks not covered by remittance from the depositor within seven days would be covered by the bank's automatic withdrawal of sufficient funds from the depositor's savings account. The Board considered that such a practice constituted misuse of savings deposits and involved a payment of interest on a demand deposit in contravention of section 19 of the Federal Reserve Act. The Board therefore adopted the transfer limitations to preserve a meaningful difference between demand deposits and savings deposits.

<u>Board Authority to Remove Transfer Limitations in Two States</u>: Absent a clearer showing of the relevance and benefit of removal of transfer limitations to the current NOW experiment (or some exigent circumstances necessitating Board action to protect the public) we believe there exists a significant question as to whether the Board's authority under section 19 of the Federal Reserve Act (to define various deposits and prescribe regulations as it may deem necessary to effect the purposes of that section), also includes authority to establish withdrawal or transfer rules in two states different from those applied in the rest of the country.

The Board has the authority to establish different interest <u>rate limitations</u> for different classes of deposits ". . . according to the nature and location of member banks or their depositors" but no such specific authority to establish different rules applicable to savings accounts is contained in the Act. Clearly, uniformity of System rules and regulations regarding various types of deposits held by member banks was one of the intended goals of Congress when it placed authority in the Board to define various types of deposits for member banks.

Legislative history relevant to NOW account legislation (and the bulk of public comment on NOW accounts) indicates a desire for uniformity of NOW regulations among institutions in the experiment area. In our view, removal of the present transfer limitations will create disequilibrium among institutions by restructuring all savings deposits held at member banks in Massachusetts and New Hampshire.

Such action at this time may have a disruptive rather than beneficial effect on the NOW experiment. Suspension of transfer limitations is not essential to the experiment commissioned by Congress. Because such action may in fact impede the NOW experiment through the introduction of transfer privileges for all savings deposits four months after NOW authorization by the agencies, we believe that amendment of Regulation Q only in the two state area is not necessary and therefore may be subject to successful challenge in the courts.

We believe the likelihood of a disruptive effect on the NOW experiment outweighs the possibly valid assertion that making <u>all</u> savings accounts in the test area subject to some form of transfer procedure may provide a clearer indication of the consequences of removal on a nationwide basis of the prohibition on the payment of interest on demand deposits.

Payment of Interest on Demand Deposits: The Board's notice of adoption of the present savings deposit transfer limitations (effective January 15, 1962) stated that,

> "the purpose of the amendment is (1) to prevent certain practices that facilitate the use of a savings deposit as a regular means of drawing checks on the depository bank . . ."

Board action removing or suspending savings deposit withdrawal limitations from Regulation Q would not in itself constitute authorization for Bank to pay interest on demand deposits. Such action would, however, have the practical effect of permitting the use of savings deposits in a manner closely resembling demand deposits.

Prior to adoption of the present transfer limitations it was the view of the Legal Division that a deposit may be classified as a savings deposit if (in addition to meeting requirements such as depositor eligibility) it was subject to an agreement under which the depositor is or may be required by a bank to give notice in writing of an intended withdrawal not less than 30 days before the withdrawal is made.[4/]

We concur with the Division's previously expressed view that limitations on transfers from savings deposits are not essential for maintaining the statutory distinction between savings and demand deposits. However, because removal of the limitations would have the practical effect of permitting payment of interest on funds used to cover checks, we recommend that such action not be taken during the NOW experiment in the face of recent Congressional consideration of NOW legislation. Reference to that

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4/ Memorandum, "A Legal History of Federal Regulation of Payment of Interest on Demand Deposits," by Howard H. Hackley, September 30, 1955.

consideration indicates a reluctance on the part of Congress to remove the distinction between demand and savings deposits without first reviewing the effects of the NOW experiment which, in the form approved by Congress, falls short of permitting the payment of interest on demand deposits.

Now Experiment: Bank contends that such action would "enhance" the experiment, presumably by permitting member banks to more easily compete with institutions which can offer NOWs without a 150 item limitation. As recognized by the Boston Reserve Bank, if savings deposits were made automatically transferable to a demand deposit by prior agreement, such action would provide the convenience of the NOW account without requiring the creation of a separate account. It can be expected, however, that altering the character of savings accounts to provide transfer privileges similar to NOWs would convince many potential NOW customers not to open a NOW account. An element of the NOW experiment--to determine the appeal of NOWs over present savings accounts--would be lost. It can be argued however, that making all savings accounts as convenient as NOWs may enhance the results of the experiment by providing a more accurate indication of the extent of depositor willingness to convert from demand deposit to interest bearing accounts subject to either transfer or negotiable order.

As noted by President Morris, suspension of transfer limitations will provide depositors with a convenient means to write drafts while maintaining separate interest bearing thrift accounts. This result appears consistent with the NOW rationale. On balance, however, we believe that the NOW experiment, as authorized by Congress and as currently in process, should remain undisturbed at least during the remainder of this year to provide Congress an opportunity to review the acceptance and effect of NOW accounts in the form originally authorized by the agencies. This review can be expected later this year when agency interest rate control authority is again considered by Congress.

Confining the suspension of transfer limitations to the present NOW account area in order to "enhance" that experiment is certain to be labeled discriminatory and unreasonable by member banks in other states. NOW accounts are prohibited in all states except Massachusetts and New Hampshire, therefore, the Board is directed by statute to limit NOWs to those states. No such limitation exists on the Board's authority to amend its rules regarding savings deposits to permit transfers. Judging from comments received when the Board considered NOW regulations, commercial banks throughout the country and especially those in states bordering Massachusetts and New Hampshire which have been seeking methods to offer more convenient thrift accounts will urge strongly that the suspension action apply System-wide.

Application of the proposed suspension to all member banks nationwide, during the NOW experiment, would subject the Board to Congressional criticism for taking action which may have the effect of permitting savings accounts to be used in a manner resembling NOWs before Congress and the agencies have seen the results of the NOW experiment.

<u>CONCLUSION</u>: For the reasons discussed above we believe Bank's request should be denied. Bank is able to offer NOWs and as indicated in the attached draft response (Attachment D), the Board has previously expressed its willingness to review the 150 item limitation should current monitoring efforts indicate that member banks are unable to compete on an equal basis with other institutions offering NOWs.

ATTACHMENT A

THE FIRST NATIONAL BANK OF BOSTON

RICHARD D. HILL
Chairman of the Board

February 19, 1974

Board of Governors
Federal Reserve System
Washington, D. C. 20551

Attention: Mr. Chester L. Feldberg, Secretary

Gentlemen:

In recent months changes have taken place in the Federal regulations which apply to the savings deposits and demand deposits of financial institutions in the United States. For example, new legislation has permitted banks and thrift institutions in New Hampshire and Massachusetts to offer negotiable orders of withdrawal and the Board of Governors has issued regulations covering the NOW account experiment in those states. Automatic withdrawals from savings accounts in Federal Savings and Loan Associations have also been authorized, on an interim basis. In order to enhance these experiments, the following request is made.

By this letter The First National Bank of Boston respectfully requests the Board to suspend the operation of Section 217.5 (c)(2)(i) of Regulation Q. The Regulation currently provides as follows:

> "(2) Notwithstanding the provisions of subparagraph (1) of this paragraph, no withdrawal shall be permitted by a member bank to be made from a savings deposit, through payment to the bank itself or through transfer of credit to a demand or other deposit account of the same depositor (other than of interest on the savings deposit) if such payment or transfer is made pursuant to any advertised plan or any agreement, written or oral,
>
> (i) which authorizes such payments or transfers of credit to be made as a normal practice in order to cover checks or drafts drawn by the depositor upon the bank."

The purpose to be served by suspension of subsection (c)(2)(i) is to enable commercial banks to compete on a more even footing with thrift institutions which offer NOW accounts. A depositor in such an institution is not bound rigidly by the concept of

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Boston, Massachusetts 02110

FOR FILES
Pat Roberts

genuine thrift, but rather is permitted to take advantage of the time value of money drawing interest on his balance in savings, but able to make transfers to third persons periodically without presenting a signed withdrawal order in person or by mail. The same functional result should, we feel, be allowed to customers of commercial banks who have both savings and checking accounts in the same bank. With the suspension of the provision cited above, a commercial bank, upon receipt of checks, could debit the customer's checking account in the normal way and then when insufficient funds remain in his checking account automatically move funds from his savings account to his demand deposit account. Such automatic transfers would be made pursuant to an agreement with each participating customer.

We believe that this request is fully in the public interest, since it would permit commercial banks to offer, on a fair competitive basis, benefits to the public. The proposed suspension of the subsection would simplify the customer's bookkeeping since he would receive one statement for his checking account and savings account. Furthermore, by permitting commercial banks to make transfers between the accounts automatically, the efficiencies of their computer operations could be more fully realized.

This should amount to a significant improvement in the payments mechanism.

If we can furnish further information in support of this request, please let me know.

Yours truly

Richard D. Hill
Chairman

Copy to:
Mr. Frank Morris, President
Federal Reserve Bank of Boston

ATTACHMENT B

209

FEDERAL RESERVE BANK OF BOSTON

FRANK E. MORRIS
PRESIDENT

BOSTON, MASSACHUSETTS 02106
TELEPHONE (617) 426-7100

April 22, 1974

Mr. Chester B. Feldberg, Secretary
Board of Governors of the
Federal Reserve System
Washington, D. C. 20551

Dear Mr. Feldberg:

The First National Bank of Boston has requested suspension of Regulation Q prohibitions on transfers from a savings account to a demand deposit account of the same depositor as a normal practice in order to cover checks drawn by the depositor. This Bank believes that the requested suspension is warranted, subject to qualifications discussed below which relate to the NOW account experiment.

The proposed change in Regulation Q would permit commercial banks to offer their customers checking accounts in combination with savings accounts so that an overdraft of the depositor's checking account would be covered by automatic transfer from the depositor's savings account. First National argues that commercial banks would then be able "to compete on a more even footing with thrift institutions which offer NOW accounts." Since banks in Massachusetts may themselves offer NOW accounts on an exactly equal footing with thrift institutions, First National's request really signals a preference for an alternate form of account arrangements. The customer would benefit since there would be no need to open a separate NOW account; instead, savings and demand accounts would be combined in a single statement account. From the banks' point of view, it is argued that computer handling of combination accounts would be more efficient.

The computer efficiency argument is more pertinent to First National's present circumstances than to commercial banks generally. In recent advertising, the bank has aggressively promoted free checking accounts tied to savings accounts (minimum balance $5.00; see attachment.) Thus, its computer operations are presently set up with the capacity to handle demand and savings accounts in combination. If an automatic transfer provision were permitted and the bank continued to offer the combination free of charge, the resulting package would represent the functional equivalent of no-service-charge NOW accounts, which are offered in Massachusetts by 3 commercial banks and 31 thrift institutions (as of March 29.)

We see no compelling reason to deny the requested change in Regulation Q, provided that the suspension is effected explicitly as part of the NOW account experiment in Massachusetts and New Hampshire. Therefore, we would not favor the suspension if it could not be limited to the two states. Similarly, in the event that commercial banks' savings account interest rate ceilings are increased in the future, we would require that interest on savings deposits in a combination account with automatic transfer provisions be paid at a rate no higher than the permissible rate payable on NOW accounts.

Sincerely,

Frank E. Morris

Frank E. Morris

Attachment

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FEDERAL RESERVE BANK
OF BOSTON

ATTACHMENT C

EMORANDUM

Date March 14, 1974

): Mr. Morris

Subject Request re Regulation Q from First National Bank of Boston

om: Mr. Stone

By letter of February 19 to the Board of Governors, copy to you, The First National Bank of Boston requested suspension of that portion of Regulation Q that prohibits transfers from a savings deposit to a demand deposit of the same depositor if such transfer is made pursuant to any advertised plan or any agreement which authorizes such transfers to be made as a normal practice in order to cover checks drawn by that depositor.

In my opinion that request should be denied.

The section of Regulation Q in question is sometimes referred to as the Park Ridge section, designed to prevent the regular use of savings deposits and withdrawals therefrom to cure deficits in demand deposits, as had been proposed in the early 1960's by the Citizens Bank and Trust Company, Park Ridge, Illinois. As you know, the Regulation Q section in question was a compromise of what the Park Ridge Bank first proposed; and that bank, at the present time, markets a deposit plan that takes full advantage of that compromise provision.

The request of the First does not limit itself to Massachusetts and New Hampshire; I recommend denial of the request whether it is construed as limited to those two states or to the nation as a whole.

The general thrust of the First's position in support of its request is that commercial banks should be able to compete on a more equal footing with thrift institutions which offer NOW accounts. It points out, quite correctly, that the depositor in a commercial bank may not arrange for transfers to be made from his savings deposit to his demand deposit, and when coupled with the statutory prohibition against the payment of interest on demand deposits, the commercial bank is placed at a competitive disadvantage vis-a-vis the savings banks offering a NOW account. You will recall that this disadvantage was a major point in the brief by the Massachusetts Bankers Association in presenting its views during the period Congress was wrestling with the question of what to do with NOW accounts.

The clearest answer to the First is to suggest that it might compete with the thrift institutions by offering NOW accounts. It could not do so prior to the federal legislation that permits the regional experiment, but it is quite clear that both under the statute and under the amended Regulation Q a commercial bank in the two states can offer NOW accounts and provide for automatic transfers therefrom to a checking account of the same depositor.

It is clear that a suspension of the Regulation Q provision as requested by the First would mean that the member banks would, in effect, be able to pay interest on demand deposits. Removal of the statutory prohibition against that practice may be forthcoming, and Governor Mitchell may be quite right in suggesting a "family account" that would permit easy transfers to and from checking accounts--but until those changes take place, it is premature to grant the request of the First.

LH

yb

ATTACHMENT D

Mr. Richard D. Hill
Chairman of the Board
The First National Bank of Boston
Boston, Massachusetts 02100

Dear Mr. Hill:

This responds to your letter of February 19, 1974, requesting that the Board suspend the operation of Section 217.5(c)(2)(1) of Regulation Q which provides limitations on the transfer of funds from a savings deposit to the depository bank or through transfer of credit to a demand or other deposit account of the same depositor.

The Board has reviewed your request in light of the NOW experiment presently being conducted in Massachusetts and New Hampshire and has determined that such action to suspend the present transfer limitations should not be taken at this time. As you know the Board and the other Federal financial supervisory agencies have jointly instituted a monitoring program to enable these agencies and Congress to assess the acceptance and financial effects of the use of NOWS in the experiment area.

Because the NOW experiment as authorized by Congress and the agency monitoring effort have been in place for only four months, data thus far received are inadequate to permit accurate assessment of the use of NOWS in the form existing in the two States at the time Congress considered NOW legislation and authorized continued NOW usage under experimental conditions. Removal of the transfer limitations as to all savings deposits at this time would significantly change the NOW experiment environment and thereby may make more difficult accurate evaluation of the date received thus far.

These considerations, in addition to the fact that data thus far available do not indicate that the Board's item limitation is inhibiting member banks' ability to offer NOW services on an equal footing with other financial institutions, convince the Board that the suspension of transfer limitations for all savings deposits is not warranted at this time. The Board is continuing to monitor closely the use of NOWS and is prepared to review its present regulatory requirements should data indicate that additional regulatory actions appear necessary.

Very truly yours,

Chester B. Feldberg
Secretary of the Board