Competitive equality and Federal Reserve membership— The Board of Governors' proposal

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> To promote competitive equality among member banks and other financial institutions and to encourage membership in the Federal Reserve. . .

This is the stated objective of a Federal Reserve proposal sent to Congress July 7. There are two components of the proposal: legislation requiring all financial institutions to hold reserves at the Federal Reserve against transaction accounts and a comprehensive program providing for explicit pricing of Federal Reserve services and for reducing the cost of Federal Reserve membership.

Some positive action is needed to stem the withdrawal of banks from membership in the Federal Reserve. Over the past decade, the percentage of commercial bank deposits held at member banks declined from 82.5 percent at the end of 1967 to 72.8 percent by the end of 1977. During that time, 551 banks, including 117 banks in the Seventh District, withdrew from membership. While the number of banks in the United States increased by 985 over those ten years, the number of member banks declined by 403.

Within the Federal Reserve, there has been growing concern that without corrective action, the trend would continue, undermining the nation's financial system and the ability of the Federal Reserve to implement monetary policy. As stated in the proposal:

> . . . a continued, probably an accelerated, erosion of membership and of deposits subject to regulation by the Federal Reserve . . . threatens to weaken the nation's financial system, as more and more of the nation's payments and credit transactions are handled outside the safe channels of the Federal Reserve, as fewer and fewer banks have immediate access to Federal Reserve Bank credit facilities, as a national presence in bank supervisory and regulatory functions becomes increasingly diluted, and as implementation of monetary policy becomes more difficult.

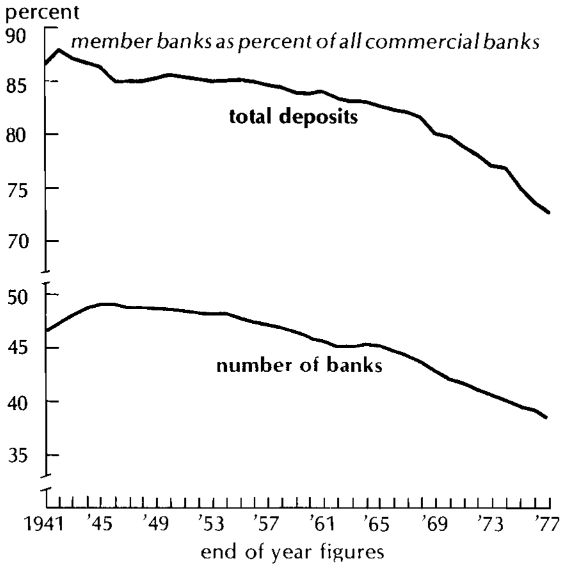
Attrition in Federal Reserve membership stems primarily from increasing competitive inequities between member banks and other financial institutions—that is, from the increasing burden of membership.

Burden of membership

Competitive inequities between member and nonmember banks result largely from differences in reserve requirements and types of assets that can be used to satisfy the requirements. Member banks have to hold specific percentages of their demand and time deposits in the form of vault cash and balances at the Federal Reserve. Neither earns interest.

Reserve requirements for nonmember banks vary from state to state. Illinois is the only state that imposes no statutory reserve requirements. All other states allow a nonmember bank to satisfy requirements with vault cash, demand balances at correspondents, or other assets a bank holds in the normal course of business. Many states, including Michigan and Wisconsin, allow

Federal Reserve membership declines



some of a bank's reserves to be held in the form of interest-earning assets. And some states, including Iowa and Indiana, allow cash items in process of collection to count as reserves.

On average, member banks hold a higher proportion of noninterest-earning cash assets (vault cash, reserve balances at Federal Reserve Banks, and demand balances due from banks) than do nonmember banks of comparable size. Earnings on cash assets that member banks have to forego but nonmember banks do not represents a cost member banks have to bear—a burden of membership.

The burden has become more pronounced in recent years, partly because of inflation and the associated rise in interest rates and partly because of increased competition from institutions other than banks in providing third-party payment services. Instruments such as credit union share drafts and negotiable orders of withdrawal (NOWs) work much like bank checking accounts. The big difference is that nonbank institutions do not have to hold noninterest-earning reserves against these check-like deposits as member banks do.

Universal reserve requirements

A key element of the Federal Reserve proposal is the Reserve Requirements Act of 1978. Under the bill submitted for congressional action, transaction accounts of more than $5 million at any depository institution would be subject to reserve requirements established by the Board of Governors of the Federal Reserve System. The bill defines a *transaction account* as "a deposit or account on which the depositor or account holder is allowed to make withdrawals by negotiable or transferable instrument or other similar item for the purpose of making payments to third persons or others." Like demand deposits, NOWs and share drafts are clearly included. A *depository institution* is defined for purposes of this act to include all federally insured commercial banks, mutual savings banks, savings and loan associations, and credit unions.

The first $5 million of an institution's transaction accounts would not be subject to reserve requirements. Specific reserve requirement ratios on transaction accounts exceeding $5 million would be determined by the Board of Governors within statutory ranges. Demand deposits of all depository institutions would be subject to average reserve requirements within a range of 7 to 22 percent. Similarly, all depository institutions would be required to hold reserves averaging from 3 to 12 percent on transaction accounts other than demand deposits.

The bill also proposes a downward adjustment in the statutory range of average reserve requirements on member bank time and savings deposits. Set now at 3 to 10 percent, the proposed legislation would change the range from 0.5 percent to 10 percent.

Required reserves of all depository institutions would be kept in the form of vault cash and reserve balances at Federal Reserve Banks. Institutions that are not members of the Federal Reserve would also have the choice of keeping reserves in a member bank or in the Federal Home Loan Bank, as long as the member bank or FHLB held the funds in the form of Federal Reserve balances. Funds

Proposed universal reserves legislation sets new statutory ranges on requirements

Current: Type of deposit	Statutory range (percent)
Net demand deposits	
Reserve city member banks	10 to 22
Other member banks	7 to 14
Time and savings deposits	
Member banks	3 to 10

Proposed: Type of deposit	Statutory range (percent)
Net demand deposits	
All depository institutions	7 to 22
Other transaction accounts	
All depository institutions	3 to 10
Time and savings deposits (other than transaction accounts)	
Member banks	0.5 to 10

passed through to the Federal Reserve would not be subject to reserve requirements or federal deposit insurance assessment.

If Congress passes uniform reserve requirements on transaction accounts as proposed in the bill, all depository institutions will compete for these accounts on a more equal basis. To ease the impact of these requirements on institutions that are not members, the Board has proposed that reserve requirements be phased in over a four-year period.

Once all depository institutions were subject to the same reserve requirements on transaction accounts, the Federal Reserve would be better able to implement monetary policy. Furthermore, periodic reports that the Board would be authorized to obtain on deposit liabilities of all depository institutions would also provide the basis for significant improvement in the Federal Reserve's monetary statistics.

Proposed Federal Reserve program

At the same time that the Board of Governors is seeking universal reserve requirements legislation, it is also considering a program that includes:

- Restructuring and reducing reserve requirements on demand deposits.
- Charging for services provided by the Federal Reserve.
- Compensating for required reserve balances held at Federal Reserve Banks.
- Transferring part of the Federal Reserve surplus to the Treasury during the changeover.

The proposed changes in reserve requirements on demand deposits are expected to partially offset the current burden of membership. In turn, the transfer from Federal Reserve surplus is expected to offset any Treasury revenue loss resulting from the program's implementation.

Competitive equity between member banks and nonmember institutions requires that all users of Federal Reserve services be treated equally. Explicit pricing provides a mechanism by which Federal Reserve services can be offered on an equal basis to all institutions in the same market area. At present, however, member banks effectively pay for Federal Reserve services by maintaining reserve balances. By imposing explicit charges for services without compensating member banks on the balances they hold, the Federal Reserve would effectively increase the burden of membership.

In the absence of universal reserve requirements, payment of interest on reserves forms an integral part of the Federal Reserve's program. Charging for Federal Reserve services without compensating member banks for the balances they hold would only aggravate the burden of membership. Should Congress enact the proposed universal reserve requirements legislation, however, the Board would reevaluate the need to charge for services and pay interest on reserves in light of the legislation's effect on membership, monetary control, and operations of the payments system.

Reserve requirement actions—The Board would move in two phases, both to simplify the structure of reserve requirements and to reduce the reserve requirements on net demand deposits of member banks. The proposed schedule for reserve requirements on net demand deposits is shown in the accompanying table. A reserve city bank would be redefined as a bank with net demand deposits in excess of $600 million, compared with the current $400 million definition.

Such action would release an estimated $5 billion in reserves. Of that, about $2.75 billion would be released in the initial phase of the program. Only member banks with net demand deposits of less than $2 million would be unaffected by these actions. This is because reserve requirements on net demand deposits at banks of that size are already at the statutory 7 percent minimum.

Charges for services—In moving toward explicit pricing of Federal Reserve services, the Board intends to be competitive in setting prices so as to encourage innovations in the private sector, to promote competitive equality by charging all users of Federal Reserve services in the same market area on an equal basis, and to ensure a continued efficient functioning of the nation's payment mechanism.

Plans call for the proposed schedule of charges, which would be submitted for public comment, to be implemented in two phases. In the first phase, charges would be imposed on Federal Reserve payments services, such as check processing, check transportation, and automated clearing house services. Annual revenue to the Federal Reserve in the first phase has been estimated at about $225 million. That estimate is based on the current volume of services the Federal Reserve provides, and the associated costs, direct and indirect.

In the second phase, charges would be imposed for such services as shipment of currency and coin to member banks, transfer and settlement of reserve balances, and purchase, sale, safekeeping, and clearing of securities. Charges would not be imposed on such governmental-type functions as bank examinations, monetary policy, and some activities associated with the issuance and

Under the Federal Reserve program, member bank reserve requirements on net demand deposits are restructured and reduced in two stages

Current		Proposed			
		First phase		Second phase	
Net demand deposits	Reserve requirement	Net demand deposits	Reserve requirement	Net demand deposits	Reserve requirement
(millions)	*(percent)*	*(millions)*	*(percent)*	*(millions)*	*(percent)*
$ 0-2	7.00	$ 0-10	7.00	$ 0-200	7.00
2-10	9.50	10-200	9.50	200-600	10.00
10-100	11.75	200-600	12.50	over 600	16.25
100-400	12.75	over 600	16.25		
over 400	16.25				

destruction of Federal Reserve notes. Once both phases have been implemented, estimated annual revenue to the Federal Reserve would be about $410 million.

In setting the price structure, the Board of Governors would be guided by the following general principles:

1. Services for which the Federal Reserve charges would usually be priced separately by geographic area, activity, and class of work done. The price schedule, based on explicit per-item charges, would be as simple as possible. Prices would be adjusted as the Federal Reserve gained experience with service charges and saw the effects of pricing in the markets in which it operates.

2. No significant changes would be made in the services provided at the time charges are initially imposed. Once charges are in place, however, some Federal Reserve offices might find revision of their operating policies and prices is needed to maintain competitiveness and to enable the System to maintain a basic level of service nationwide.

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

Guidelines for the pricing of Federal Reserve check and automated clearing house services include the following:

- Charges for check services would be imposed on depositing institutions.
- Prices for interoffice items deposited locally might include both a local processing and a uniform national charge.
- Charges for automated clearing house items could either be imposed on ACH associations or directly on financial institutions using the service.
- Prices for automated clearing house services would be set to encourage the use of the services and to reflect mature volumes of use.

Once charges on payments services are imposed, all depository institutions with third-party payment powers can deposit intraregional checks and drafts at Federal Reserve regional check processing centers—whether the institution is a member of the Federal Reserve or not. Commercial banks that are not members can deposit intraregional checks and drafts at RCPCs now. Nonmembers would be charged the same as members, and settlement would still be through reserve accounts of member banks.

When all service charges have been implemented and the effect on membership and the functioning of the payments mechanism has been evaluated, the Board expects to give all nonmember depository institutions full and direct access to Federal Reserve payments services, as well as other operational services of the Federal Reserve.

Compensation for reserve balances—As it began charging for services, the Federal Reserve would phase in payment of interest on reserve balances. To the extent nonmembers hold balances at Federal Reserve Banks, they will be treated the same as balances held by members. Compensation to nonmembers will be figured on the same basis as compensation to members.

In the first phase, interest at 2 percent would be paid on required reserve balances held at Federal Reserve Banks. First-phase interest payments to member banks would total an estimated $430 million. In the second phase, the interest rate on the first $25 million of required reserve balances would be one-half percentage point less than the average return on the Federal Reserve System's portfolio, valued at book. The rate paid on required balances over $25 million would be maintained at 2 percent.

Based on the System's average return in 1977, a rate of 6 percent would be paid on the first $25 million. Based on current levels of member bank deposits, the estimated second-phase interest payments to member banks would be about $765 million annually.

There would be a limit, however, on the amount that could be paid to member banks after deductions for service charges. As part of the program, the Board of Governors has submitted a second piece of legislation that would set the maximum amount of the net compensation (interest payments less service charges) at 7 percent of the Federal Reserve's net earnings before payment of interest on required reserve balances.

Effect on Treasury revenues— While the program would reduce the burden of membership, the Board is also aware of the program's likely effect on Treasury revenues. Nearly all of the Federal Reserve's net earnings are now paid to the Treasury. Technically these payments are interest on Federal Reserve notes. In 1977, for example, the Federal Reserve paid the Treasury $5.9 billion—98.2 percent of its net earnings.

In the absence of universal reserve requirements, the loss in Treasury revenues over the three years while the program is implemented is expected to run about $575 million. Over this transition period, the Federal Reserve would transfer a like amount from the surplus accounts of Federal Reserve Banks to the Treasury, leaving Treasury revenues unaffected during the changeover.

Without the program, continuation of the decline in membership seems inevitable. The current rate of attrition would lead to a loss in Treasury revenues of about $80 million in four years. If the rapid rate of attrition experienced in New England became prevalent, the loss to the Treasury could be as much as $200 million.

Once the program was fully implemented, however, the cost to the Treasury above what it would have been without the program should be minimal. Revenues to the Treasury could, in fact, increase if the program led to increased membership in the Federal Reserve—and with universal reserve requirements, gains for the Treasury could be even greater.

Summary

Because of growing competitive inequities between member banks and other financial institutions, banks are withdrawing from Federal Reserve membership at an increasing rate. Continued erosion of membership threatens to undermine the nation's financial system and the ability of the Federal Reserve to implement monetary policy.

Under the proposal submitted by the Federal Reserve, competitive equality among financial institutions would be enhanced. All depository institutions would be made subject to the same reserve requirements on transaction accounts and all users of Federal Reserve services would be charged on an equal basis.

Membership in the Federal Reserve would be made less burdensome by restructuring and reducing reserve requirements on net demand deposits and by paying interest on required reserve balances at Federal Reserve Banks.