Some Current Banking and Economic Problems*

By WILLIAM F. TREIBER

First Vice President, Federal Reserve Bank of New York

It is a great pleasure to be with you today. You, as state bank supervisors, and we in the Federal Reserve System have many common interests. Both are interested in promoting a sound banking system that will continue to develop and to serve effectively the nation and its people. You have the responsibility of chartering and supervising banks organized under state law. We in the Federal Reserve have a secondary responsibility of supervising some of those banks. We are also concerned with the preservation of the value of our nation's money, for we have been delegated responsibilities in this respect by the Congress which under the United States Constitution has the power to coin money and regulate the value thereof. Today I propose to discuss with you, as we see them, some recent developments and current problems in promoting an efficient and sound banking system, in preserving the value of the dollar, and in promoting our other national economic goals. Most of these problems involve Federal legislation in one way or another.

REGULATION OF INTEREST RATES PAID BY FINANCIAL INSTITUTIONS

Public Law 89-597, which was enacted September 21, 1966, broadened and placed on a discretionary basis the authority of the Federal Reserve Board and the Federal Deposit Insurance Corporation (FDIC) to limit interest rates paid by banks on time and savings deposits. It granted similar authority to the Federal Home Loan Bank Board to limit interest rates paid by savings and loan associations, and required prior consultation among all three agencies before any one agency could prescribe new rate limits.[1] The law is temporary. On September 21, 1967, the prior provisions of law will be restored unless the Congress enacts new legislation. On July 17, 1967, the Senate voted to extend for two years the provisions of Public Law 89-597. The Senate bill is now before the Committee on Banking and Currency of the House of Representatives.

I would like to comment on two aspects of this temporary legislation: (1) the discretionary nature of the authority to limit the rate of interest paid by commercial banks, and (2) the authority to limit interest rates paid by mutual savings banks and savings and loan associations. I think that these provisions, as well as other provisions upon which I will not take the time to comment, should be made permanent.

COMMERCIAL BANKS. Prior to the enactment of the temporary legislation last year, the Federal Reserve Board was required by law to establish maximum rates on time and savings deposits in member banks, and the FDIC was required to establish maximum rates on similar deposits in insured nonmember banks.[2] The objective of the requirement, enacted more than three decades ago, was to help assure sound banking. Improved bank examination and supervision in recent decades make continuous regula-

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[1] The law also expanded the range within which the Federal Reserve Board may vary reserve requirements on time and savings deposits, and it authorized the Federal Reserve Banks to conduct open market operations in United States Government agency obligations.

[2] Since 1938, insured nonmember mutual savings banks had been expressly exempted by the FDIC from the maximum rates established by it for insured nonmember banks.

tion of interest rates unnecessary as a means of preventing destructive competition and the resultant acquisition of unsound assets.

In general, the public interest is best served when the forces of supply and demand are permitted to reflect themselves in prices, including interest rates. The relationship between buyers and sellers, or borrowers and lenders, is likely to be more equitable, and the allocation of resources is likely to be more satisfactory, when prices and interest rates are free to reflect market forces. Yet there may be times, and 1966 was such a time, when the establishment of maximum interest rates is necessary either to prevent institutional practices in the payment of interest that would be inconsistent with the safety and liquidity of a significant number of institutions or to supplement other governmental policies to promote our national economic goals. These factors counsel continuation of the authority on a discretionary basis. The exercise of such discretionary authority, it seems to me, should be limited to such special situations.

MUTUAL SAVINGS BANKS AND SAVINGS AND LOAN ASSOCIATIONS. Although prior to 1966 the Federal Reserve and the FDIC were required to establish maximum interest rates for banks, no Federal supervisory authority was directed or even authorized to fix maximum rates of interest payable by savings and loan associations.

The absence of a maximum interest rate for thrift institutions gave them, at times in the past, a competitive edge over commercial banks in attracting funds. However, as interest rates rose rapidly in 1966, the thrift institutions were faced with very strong competition on the part of not only banks but also marketable securities including those of the United States Government. Because most of the investments of thrift institutions had been made for long terms when interest rates were lower, their earnings did not rise as rapidly as did current interest rates.

The temporary legislation specifically authorized the FDIC to limit the rate of interest paid by insured mutual savings banks, and it authorized the Federal Home Loan Bank Board to limit the rate paid by insured savings and loan associations. The authority was granted to restrain some thrift institutions from trying to match or to better competitive rates available to savers. Although the rates paid by insured commercial banks were already subject to Federal Reserve or FDIC control, it was not feasible to restrict further the rates paid by commercial banks while the rates paid by competing thrift institutions were subject to no supervisory control. The experience of 1966 demonstrated the desirability of vesting in the FDIC and the Federal Home Loan Bank Board, on a permanent basis, discretionary authority to limit the rates of interest paid by insured thrift institutions.

DISCOUNT WINDOW ADMINISTRATION

Another problem on which I would like to comment is the administration of the Federal Reserve "discount window". In recent years the Federal Reserve has sponsored legislation that would eliminate the outmoded technical requirements regarding the "eligibility" of customers' paper presented at the discount window to secure advances by the Reserve Banks to member banks. The System has also been engaged in a basic reappraisal of the functioning of the discount window in the light of the changes in the banking system and the financial markets over the past decade.

ELIGIBILITY LEGISLATION. In April 1967, the Senate passed S.966, streamlining discount window operations. The bill is now before the House Committee on Banking and Currency. Enactment of the bill would not cause a dramatic or abrupt change in the type of collateral offered by member banks to secure their borrowings at the Federal Reserve Banks. It would still be more convenient most of the time for member banks to pledge U.S. Government obligations and simple notes of customers as collateral for their borrowings. But this is important legislation for member banks that have limited holdings of unpledged Government obligations or that have small amounts of "eligible paper" in their loan portfolios. For these banks, access to the discount window under the circumstances specified in the Reserve Board's Regulation A would be facilitated. The legislation should also prove helpful to any member bank encountering an emergency or any other situation requiring substantial assistance from a Federal Reserve Bank.

The Federal Reserve System is already engaged in forward planning to process the wide variety of collateral that may be tendered at the discount window to support borrowings. The System has organized and has commenced to operate a school to train Federal Reserve discount personnel in collateral appraisal. As we in the Federal Reserve prepare for enactment of this legislation, member banks, too, would be well advised to consider how they may take advantage of the new possibilities when they materialize.

STUDY OF DISCOUNT MECHANISM. It is too early to report the conclusions of the fundamental study of the discount mechanism. It is not unlikely, however, that there will be recommendations leading to a greater use of the discount window to the advantage of both member banks and the Federal Reserve.

STUDY OF BANK LIQUIDITY AND CAPITAL

The Federal Reserve System is also engaged in another study which is even more closely associated with your interests and responsibilities as bank supervisors. The events of 1966 highlighted the importance of reexamining our approach to member bank liquidity and capital.

BANK LIQUIDITY. Traditionally, a bank's need for liquidity has been thought of in terms of a possible drop in deposits. The events of last year brought into sharp focus the necessity of considering also a bank's ability to meet potential credit demands, especially unexpected demands representing legitimate needs in the community. Many banks found it difficult to shift assets to meet such needs in a period of rapidly rising interest rates. Liquidity analysis should take into account not only potential deposit losses but also potential credit demands.

Changing banking practices have highlighted the importance of liability management. Banks have found that sometimes an increase in liabilities may be a more feasible way to obtain loanable funds than a sale or other disposition of assets. Banks and bank supervisors need to know more about the potential impact on a bank of an increase in various types of liabilities.

BANK CAPITAL. During the past decade, bank assets and deposits have grown more rapidly than retained earnings. The growth in time and savings deposits, coupled with the steady rise in interest rates paid on such deposits, has brought a sharp increase in total bank expenses in relation to total assets. In addition, the shift in the composition of bank assets from securities to loans, while yielding greater income to offset higher costs, has increased the relative amount of risk assets. Consequently, for most banks the ratio of capital funds to total resources has declined, while the ratio of risk assets to total resources has risen.

A number of banks have increased their capital by selling securities. Many more need to do so. All bank supervisors are interested in the continued soundness of the banks they supervise, including the maintenance of a capital position adequate to enable the banks to serve their communities and remain strong and competitive.

STUDY OBJECTIVES. The study being undertaken by the Federal Reserve has two objectives: (1) developing improved standards for measuring a bank's liquidity, and (2) formulating a guide for measuring the capital needs of a bank and for determining appropriate ways to meet such needs. We expect to share the results of the study with you, and we trust that they will be helpful.

PROTECTION OF PUBLIC DEPOSITS

The laws of many states require that banks receiving deposits of the state or its political subdivisions secure those deposits by the pledge of U.S. Government obligations or other specified types of securities. Similarly, banks must pledge collateral to secure United States Treasury Tax and Loan Accounts and other U.S. Government deposits. A decade or more ago, when most banks held large quantities of eligible securities, there was not much of a problem in making the pledge; but in recent years as loan demands have been heavy and banks have reduced their securities holdings, many banks have experienced some difficulty in meeting the pledge requirements and at the same time maintaining desirable flexibility with respect to their investment portfolios. It has been estimated that over $45 billion of collateral are tied up in such pledges.

Most state laws that require the pledge of assets to secure public deposits exempt the FDIC-insured portion of such deposits from the pledging requirements. There is a similar exemption with respect to U.S. Government deposits. Last year an advisory committee of banking experts appointed by the New York Superintendent of Banks to assist him in a comprehensive reappraisal of banking laws and regulations recommended to the Superintendent that appropriate statutes be amended to provide for full FDIC insurance of public deposits as a substitute for the pledging of assets.[3] Presumably upon the enactment of Federal leg-

[3] *Second Report of the Advisory Committee on Commercial Bank Supervision* submitted to the Superintendent of Banks of the State of New York, September 19, 1966. In summarizing its recommendations, the Committee said on page 9:

> *Security for Public Deposits.* In order to provide security for the repayment of public deposits and at the same time to eliminate the onerous restrictions on the management of bank assets and the costs associated with the pledging of assets as security for such deposits, this Committee recommends that appropriate statutes be amended to provide for full FDIC insurance of public deposits as a substitute for the pledging of assets.

In a study prepared in 1967 for the Trustees of the Banking Research Fund of the Association of Reserve City Bankers, entitled *The Pledging of Bank Assets, A Study of the Problem of Security for Public Deposits,* Charles F. Haywood, Dean and Professor of Economics of the College of Business and Economics, University of Kentucky, said (page 8):

> The final conclusion of this study is that the answer to the pledged-assets problem should be sought within the context of Federal deposit insurance and that an early effort in this direction would be most timely.

islation providing for such FDIC insurance, the legislatures of those states that do not exempt insured deposits from pledging requirements would adopt legislation eliminating the pledge requirements. I think the proposal provides a constructive solution of the problem.

The proposal would protect public funds and simplify the operations of public officers responsible for the funds. The proposal would benefit practically every bank. It would give the bank greater flexibility in the management of its investment portfolio; it would increase the bank's effective liquidity because securities now immobilized as collateral for public deposits would become available for sale or for pledge as collateral for borrowing at the Reserve Bank; it would simplify a bank's internal operations in handling public deposits; and it would simplify operating relationships between the bank and the Federal Reserve Bank in its custodial, discount, and fiscal agency functions.

RESERVE REQUIREMENTS AND DISCOUNTING PRIVILEGES

Another important problem involves the role of commercial bank reserves. On March 15, 1967, Senator Sparkman, Chairman of the Senate Committee on Banking and Currency, introduced S.1298 at the request of the Federal Reserve Board. The bill has three principal provisions:

(1) it would make reserve requirements applicable to all insured commercial banks;
(2) it would eliminate the present classification of all member banks as reserve city banks or as "country" banks, and establish a system of graduated reserve requirements under which the reserves required on a bank's demand deposits would depend primarily upon the amount of its deposits rather than its location; and
(3) it would afford all insured commercial banks access to Federal Reserve discount facilities.

UNIVERSAL RESERVE REQUIREMENTS. Historically, bank reserves were that part of the assets of a bank specially kept in cash, or in assets readily convertible into cash, as a reasonable provision for meeting demands upon the bank. The basic purpose of bank reserves is now quite different from what it used to be. Today the primary purpose of bank reserves is to serve as a fulcrum for the implementation of monetary policy. The monetary policy of the Federal Reserve is directed to the promotion of our national economic goals of maximum sustainable economic growth, reasonable price stability, maximum practicable employment, and equilibrium in international payments. The Federal Reserve promotes these goals by influencing the availability and cost of credit. Additions to bank credit generally bring additions to bank deposits, and the banks then need additional reserves to support the additional deposits.

Under the Federal Reserve Act, the deposits of a member bank may not exceed a given multiple of its reserves, and its reserves must consist of currency and coin or deposits in the Reserve Banks. The basic source of such reserves is the Federal Reserve Banks which, through open market and discount operations, create reserves. By making reserves readily available, or by making them less readily available, the Federal Reserve System influences the ability and willingness of member banks to make loans and investments. This activity of the Federal Reserve involves the performance of a national function delegated to the Federal Reserve by the Congress. It is a function similar to that performed by central banks in other countries throughout the world.

Deposits in nonmember banks are no less a part of the money supply of the country than those in member banks. Yet reserve requirements applicable to nonmember banks do not play a direct role in the implementation of monetary policy, and in general they are less onerous than those applicable to members of the Federal Reserve System. In one state there are no reserve requirements for nonmember banks. In many states, the form in which reserves may be held is more favorable to nonmember banks. For instance, in a number of states, reserves may be held partly in the form of securities. Furthermore, correspondent balances, which nonmembers would maintain in some amount even in the absence of reserve requirements, and from which they derive benefits, serve to satisfy part or all of state reserve requirements. The difference in reserve treatment of member banks and nonmember banks tends to confer a competitive advantage on nonmember banks.

It is generally recognized that an effective national monetary policy is essential to a sound banking system and the economic well-being of the country. Nonmember banks enjoy the general benefits of such policy as well as the specific benefit of Federal deposit insurance, but they avoid the cost of the reserve requirements established to effectuate national monetary policy. Monetary policy cannot have its maximum impact when it fails to have a direct effect upon a substantial number of banks.

In my view, the proposal for universal reserve requirements would contribute to the more effective implementation of national monetary policy, and would not adversely affect the dual banking system. There would be no impairment of the right of a state to charter a bank, to determine the extent to which it should be permitted to have branches, to determine its lending and investment powers, and to regulate, examine, and supervise it. But in an area of national concern, in promoting our nation's economic goals, the proposal would put all banks on an equal footing.

GRADUATED RESERVE REQUIREMENTS. With graduated reserve requirements, the reserves required of a bank in respect of its demand deposits would depend on the size of its deposits rather than its location. A smoothly graduated system would permit each bank to maintain a relatively low reserve against the first few million dollars of its demand deposits, a higher reserve against its demand deposits above this minimum and up to a substantial figure, and a still higher reserve against its demand deposits, if any, above the latter amount.

As you know, smaller banks find it necessary, in order to obtain certain services from their city correspondents, to hold a substantial portion of their assets in the form of noninterest-bearing balances at other banks. In addition, the smaller banks are less able than the larger banks to take advantage of the economies of scale. Thus, many bankers and students of banking have concluded that, as a matter of equity, the smaller banks should have a lower level of reserve requirements in order to offset to some extent the disadvantages of smallness.

With graduated reserve requirements, all banks of the same size in terms of demand deposits would carry equal reserves. As a bank grew in size and passed into a higher reserve bracket, its overall reserve requirement percentage would rise smoothly and gradually, because the higher requirement would apply only to its additional deposits. There would, no doubt, be less change in total required reserves resulting from shifts in deposits among banks in different cities, and there would be no need to struggle with the elusive problem of determining whether or not a particular city is to be classified as a reserve city.

Many people consider it desirable to work toward a goal of uniform reserve requirements under which, for example, the same percentage requirement would apply to all demand deposits in large and small banks wherever located. The proposal in S.1298 would provide flexibility. Graduated reserve requirements would be facilitated but would not be required. By permitting the Federal Reserve to move first to graduated reserve requirements, the proposal would make possible a transition to greater uniformity, or to full uniformity, should that prove desirable.

The inauguration of graduated reserve requirements or any other basic change in reserve requirements will require substantial adjustments. Federal Reserve open market operations are customarily used to facilitate the adjustment of the banking system to any change in reserve requirements. No doubt, every banker would prefer that there be no increase in the required reserves of his bank. It is obvious that, if there were no increase in the required reserves of any bank, and if the requirements of thousands of banks were reduced in varying amounts, there would be a large reduction in the general level of required reserves in the banking system; large excess reserves would be created overnight. Whether such a result would be justified and whether open market operations could adequately provide the necessary adjustment would depend on economic and credit conditions at the time of the adoption of the new reserve requirements, and such conditions cannot be predicted now. If, at such time, economic conditions called for monetary ease, the creation of the additional bank reserves would not create as great a problem as if economic conditions then called for restraint. Today, it seems to me that it would be fruitless to discuss further the details of any possible change and the problem of adjustment in the light of future economic conditions about which we know nothing.

ACCESS TO FEDERAL RESERVE DISCOUNT WINDOW. At the same time that S.1298 would establish universal reserve requirements, it would grant all nonmember insured commercial banks access to Federal Reserve advances. Through its power to create reserves, the Federal Reserve is the ultimate source of funds to the banking system as a whole. Any insured commercial bank would have the same privilege that member banks now have of borrowing from the Reserve Bank. Every insured commercial bank would know it could go directly to the Federal Reserve in case of need.

ECONOMIC OUTLOOK AND FISCAL MEASURES

A few minutes ago I referred to our national economic goals and the responsibility of the Federal Reserve to promote these goals. What is the present economic situation? What is the economic outlook?

Business activity has continued to gain momentum. As the President reported in his message to the Congress on August 3, Federal Government expenditures, particularly for defense, have continued to rise at a fast rate—much faster than indicated in the January budgetary estimates. At the same time, private spending is once more rising across a broad range. The rise in consumer prices has accelerated. Many wage settlements this year have provided increases much greater than the increase in general productivity, and wage demands in current bargaining sessions are large. Thus, pressures of increased demand on an economy with little slack, coupled with upward cost pressures, threaten an even more rapid increase in prices.

Corporations and state and local governments have borrowed record amounts in the capital markets so far this year, and in recent weeks yields on some types of long-term obligations have exceeded last summer's peaks. The prospect of large United States Treasury borrowing in the second half of 1967 and a growing belief that the rate of economic advance will accelerate sharply have weighed more and more heavily on the markets.

The United States continues to be plagued by a critical international balance-of-payments problem. Inflation at home would reduce our ability to compete in international markets; it would be detrimental to our exports and would, no doubt, increase our imports. At the same time, inflation would diminish the faith of foreign holders of dollars in the value of our currency. It would weaken the position of the dollar internationally at the very time our world-wide efforts require that confidence be sustained and strengthened.

These developments make imperative prompt action to reduce the Federal budget deficit significantly. Expenditures should be rigidly controlled and reduced as much as possible, but it is not realistic to expect large cutbacks in spending. The President has recommended a comprehensive program to increase Government revenues; the key recommendation is a temporary surcharge of 10 per cent on individual and corporate income taxes. Prompt and decisive fiscal action by the Congress would go far to help assure that the renewed growth in the economy is held to a sustainable pace with a reduction in the pressure on prices and in the tensions in the money and capital markets. It would, of course, lessen the need for monetary policy to carry an excessive share of the overall anti-inflationary effort, as was the case in 1966.

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In closing, I am sure that all of us—not only bank supervisors but also all our fellow citizens—want a sound banking system and a sound dollar. The studies and proposals I have discussed today are aimed at strengthening our financial institutions and the procedures through which our economic goals are promoted. Monetary policy and fiscal policy have a coordinated responsibility in promoting those goals. To assure a sound dollar, we need a more effective monetary machine and wise monetary and fiscal policies.