The Need for Uniform Reserve Requirements

By Thomas O. Waage*

In April, Arthur Burns, chairman of the Federal Reserve Board, presented the System's case for establishment of uniform reserve requirements for both member and nonmember banks to the Governing Council of the American Bankers Association. The proposals in that speech raised serious issues about economic equity and the effectiveness of monetary control. I would like to examine this proposal and some of its ramifications. But I would like first to blow away the disingenuous smoke screen that has been thrown around this proposal, so that we can examine the real issues.

It has been suggested that uniform reserve requirements threaten our decentralized, dual banking system. This view interprets uniform requirements as a form of compulsory Federal Reserve membership that would upset the checks and balances inherent in the dual banking system and run counter to the public interest. However, this bogey can't be given life while there are statutes providing that banks can choose a state or national charter.

Whether we have uniform reserve requirements or not, banks would still have the continuing choice, not only of national or state charter, but also of shifting from one to the other. Nor would uniform requirements change the separate regulatory rules governing member and nonmember banks. Dual banking has been with us since the Civil War and has not been weakened by major changes in banking regulation. The National Bank Act (and the tax on state bank notes) failed to strangle it, as the authors of that act hoped. And the state banking systems survived the even more profound challenge of the establishment of the Federal Reserve and the creation of the Federal Deposit Insurance Corporation (FDIC). I have no doubt that the dual banking system would also survive uniform reserve requirements.

Healthy competition between chartering authorities may have helped keep banking innovative in a period of great change. This fostering of innovation might well be sharpened by the imposition of uniform reserve requirements. Indeed, it was not that long ago that James Saxon, Comptroller of the Currency from 1961 to 1966, helped to spur desirable changes in all banking, because his innovative regulation attracted banks to national charters despite reserve requirements.

States, under uniform reserve requirements, could no longer offer reserve requirement advantages to hold their constituencies. They would have to offer better, more responsive, and more reasonable supervision. Their efforts would, in turn, keep the national supervisory authorities wide awake, and this alertness would benefit the public. In passing, it should be noted that going too far along the road of competitive responsiveness to bankers' needs and desires could run the risk of what Allan Sproul, former president of the Federal Reserve Bank of New York, described as "competition in laxity" by the regulators.

Much fear has also been expressed that the proposal would mean the death knell of the correspondent banking system (a fear, incidentally, that was also voiced when the Federal Reserve Act was adopted). It is clear, however, that all member banks have deposits at correspondent banks, in addition to balances at their Reserve Banks. Large correspondent banks furnish services—including portfolio analysis and advice, assistance in international transactions, loan participations, and so forth—that Reserve Banks do not and should not provide.

The sound and fury that has erupted since Mr. Burns's speech might give one the impression that the uniform reserve requirements proposal is new. However, the idea has been with us for decades.

In fact, the initial act establishing Federal deposit insurance, in 1933, required state banks to become members of the Federal Reserve System by a specified date to

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qualify for insurance, in effect creating uniform reserve requirements through universal membership. However, the Banking Act of 1935 extended the deadline and, before that date was reached, the membership requirement was repealed.

The substance of uniform reserve requirements was later embodied in the recommendations of different Congressional committees in 1950 and 1952. Uniform reserve requirements were endorsed by the Commission on Money and Credit in 1961, reaffirmed by the President's Committee on Financial Institutions in 1963, and restated by the Hunt Commission in 1971. In addition, the Federal Reserve Board has repeatedly urged the Congress to bring all insured commercial banks under the same reserve requirements and to provide them with equal access to the discount window.

The arguments for uniform reserve requirements therefore have been pressed repeatedly but until now have lacked the urgency that brings about reform. However, current developments in the banking system—among them the emergence of "NOW accounts" and electronic funds transfer systems in several areas of the country, as well as the continuing decline in Federal Reserve membership—give the uniformity proposal a greater immediacy.

The reasoning behind the proposal not only defines the issues involved but also underscores the need for its implementation. Let's examine some of these issues.

First, there is the question of the equity of present requirements. Some dismiss this issue by suggesting that nonmember banks have substantial reserve requirement equality with member banks, even though requirements are set by fifty different banking authorities. This argument misses the point. The controversy is not over the percentages themselves, since most states have reserve requirements percentages nominally similar to the Reserve System's. In fact, thirty-three states have demand deposit reserve requirements that are the same as, or higher than, the 12.9 percent the System imposes on a fairly typical medium to large bank—one with $200 million in net demand deposits.

But the comparability is more apparent than real. The inequity lies in the differential cost burdens associated with the types of assets that may be counted as reserves. Member banks must maintain their reserves in the form of either vault cash or deposit balances at Federal Reserve Banks.

These deposits are working balances, as well as legal reserves, that can be used for a variety of payments and transfers, including check clearing. Reserves can be drawn well below required levels, provided the average balances, plus vault cash, at the close of business from Thursday through Wednesday are sufficient to meet required reserves. Average balancing, which permits offsetting fluctuations without costly day-to-day adjustments, provides substantial short-run liquidity. Also, although member bank reserves are "noninterest bearing", they do "buy" some services.

Nonmember banks, however, have more options in meeting their reserve requirements, and these options generally lessen or, in some cases, entirely eliminate their cost burden. Some reserve assets represent no cost burden at all, because they are normally held as investments. Ten states permit use of interest-bearing United States Treasury or municipal securities to meet at least part of the requirements. And in forty-five states, including New York and New Jersey, demand balances at city correspondents can be counted.

These correspondent balances include both collected and uncollected funds. The difference between collected balances and those still in the process of collection is, of course, called interbank float—and is most significant in analyzing cost burdens. Uncollected balances are essentially "anticipated" assets, because the funds or reserves they represent are still lodged in the banks of those who wrote the checks.

Accounting practices permit all banks to classify uncollected balances as assets, and state laws, in turn, allow these "due from" balances to be counted as legal reserves. These balances amount to about 8 percent of demand deposits, or a good half of average reserve requirements, state or Federal.

Because nonmembers hold a greater percentage of their assets in a form that earns interest or buys services, they have a competitive edge over member banks and, therefore, can be inherently more profitable. Nonmember banks can use this extra profit to attract capital more effectively, or to entice business away from member banks with higher deposit and lower loan rates. This potential, perhaps more than any other argument, brings the question of equity down to a bread-and-butter level.

All commercial bankers, whether members or nonmembers, are increasingly concerned with and vocal about the unfair advantage they feel thrift institutions, which have no similar reserve burdens, have over commercial banks. The Board of Governors and the New York Fed both recognize the essential reserve requirement inequity between "thrifts" and commercial banks, especially in the light of the current trend of increasing demands by savings institutions to offer checking-account-like services to depositors. We support the principle of equal reserves on like deposits—whether time deposits at commercial banks or at thrift institutions.

However, it must be recognized that the same equity argument turned against thrifts applies with equal force to nonmember banks.

As you know, mutual savings banks in Massachusetts and New Hampshire offer depositors interest-earning accounts subject to a "negotiable order of withdrawal"—in effect, an interest-bearing checking account. Savings and loan associations in California are attempting to enter the electronic money-transfer system operated by the California Automated Clearing House. These innovations are probably the first step toward what ultimately will become a single, integrated nationwide payments system. We welcome that trend, but we believe that the costs of such a system should be equally distributed among all the institutions involved. The existing situation provides a competitive advantage for nonmember banks because they do not maintain reserve accounts at the Federal Reserve. If thrift institutions develop extensive checking powers in the future and become part of this newly emerging payments mechanism without assuming their fair share of the costs, today's inequities would be exacerbated.

In addition, monetary control will be hampered because the larger the share of money transfers made through institutions outside Federal Reserve control the less effective monetary policy will be. The way to avoid this problem is to impose uniform reserve requirements on all deposit accounts subject to money transfers.

This effectiveness of monetary control is the other major issue behind the need to impose a system of uniform requirements. The fundamental purpose of reserve requirements is not to supply bank liquidity or finance a rise in loan demand, but to permit the Federal Reserve a significant measure of control over the supply of money and credit in order to promote our national economic objectives. In this connection, it is worth noting that part of the opposition to giving the Federal Reserve power to establish reserve requirements for all banks stems from a failure to distinguish between the Federal Reserve's regulatory and central banking functions. The former is shared with state authorities, the Comptroller of the Currency, and the FDIC; the responsibility for monetary policy is not shared.

Effective management of the supply of money and credit requires that the assets held as reserves by the banking system come under the control of the Federal Reserve. The reserve requirements of the states, regardless of what their role may be in protecting liquidity, do not meet this test. This defect is a serious one.

When a nonmember bank's reserves are held as correspondent balances at a member bank, the member bank must support these balances with reserves consisting of vault cash or Reserve Bank balances, which are quite small in relation to total deposits *at the nonmember bank*.

To put the issue another way, it can be noted that a member bank needs, on average, about $1 in reserves to support $7 in demand deposits. That same $1 in reserves at a member bank supports $7 of reserves for a nonmember bank, which can then back up $50 of demand deposits.

As a result, shifts of balances between member and nonmember banks alter the quantity of all commercial banks' deposits that can be supported by a given volume of Fed reserves. As nonmember banks have become a larger part of the banking system, the link between bank reserves, bank credit, and money supply has become increasingly loose and the Reserve System's control less precise than it can or, more importantly, should be.

For example, if the Federal Reserve decides that there should be an increase in bank credit and money supply, it could buy, say, $100 million of securities in the open market, with payment for those assets being deposited in banks and thus added to their reserves. But, as we have seen, those reserves may support either seven or fifty times as much in bank assets and liabilities.

The Federal Reserve's control, if this trend continues, would be as poor as that of a fisherman trying to reel in a tuna on a line that was alternately as unyielding as an anchor chain and as elastic as a rubber band.

We know the problem is getting worse. Over the past decade, the increase in nonmember demand deposits has accounted for 40 percent of the total rise in demand deposits, twice as much as the nonmember share of all such deposits.

This trend partially reflects the rapid population growth in regions of the country served by nonmember banks. But a major causal factor is the competitive disadvantage member banks face by being required to hold reserves as vault cash or as finally collected funds at a Federal Reserve Bank.

This inequity provides a considerable incentive for newly chartered state banks to avoid Federal Reserve membership and for members to withdraw. Since 1960, about 700 banks have left the System through withdrawal or mergers. More significant, I think, just over 100 state-chartered banks have elected to join the System since 1960; nearly 1,500 newly state-chartered banks chose not to.

During 1972, five banks with deposits of $100 million or more withdrew from Federal Reserve membership. Only thirteen of the 212 new commercial banks receiving state charters last year joined the Federal Reserve. With the obvious dollars-and-cents profit margin available to stockholders, it's hard to criticize the choice.

Efforts have been made over the years to reduce the competitive disadvantage and make System membership more attractive. In 1960, permission to count vault cash in reserves clearly improved matters. Changes in Regulation D in November 1972 also helped by reducing reserve requirements against demand deposits—particularly for small member banks competing actively with nonmembers.

This past year, a seasonal borrowing privilege was established for member banks lacking adequate access to national money markets. This, too, should make membership more attractive, but measures of this kind are limited by existing legislation.

The erosion of Federal Reserve membership is a serious problem. It reduces the precision of monetary control, and has already reduced the potential for using changes in reserve requirements as an effective vehicle for monetary policy. When a large and increasing proportion of total bank deposits is untouched by reserve requirement changes prescribed by the Board, that in itself is alarming.

The loss is even greater, however, because the Board must, of necessity, consider possible changes in reserve requirements in the light of avoiding aggravation of the member banks' competitive disadvantage and possible further erosion of membership.

This inhibition has been unfortunate. There have been times when the prompt and pervasive impact of a higher reserve requirement would have unmistakably signaled that monetary policy was moving toward added restraint on the availability of money and credit. Such an occasion occurred earlier this year and, despite reservations, the System raised reserve requirements on time deposits and demand deposits. It also appealed to nonmember banks to follow the spirit of this attempt at curbing excessive credit growth by voluntarily increasing reserves in a like amount. However, the divergence in reserve requirements between member and nonmember banks has sometimes forced the Federal Reserve to turn to other measures to achieve its objectives.

These considerations argue persuasively, I believe, that reserve requirements on demand deposits at nonmember banks should be the same as those borne by Federal Reserve members.

But the most important argument for requiring reserves to be held in the form of vault cash and finally collected funds on deposit at a Federal Reserve Bank is that such reserves are Federal Reserve Bank liabilities. With the relatively inconsequential exception of coin and United States notes, vault cash consists of Federal Reserve notes. Since the Federal Reserve can and does decide whether or not to increase or decrease its liabilities—just as large commercial banks today carefully consider a strategy of liabilities management—uniform reserves would give the Board of Governors and the Federal Open Market Committee much greater influence over monetary aggregates and bank credit than they have currently.

To be sure, uniform reserve requirements would hurt nonmember banks initially. But the System could be counted on to mitigate the impact. Certainly, the transition to a uniform system could be made gradual. And there might well be consideration given to lowering the average level of reserve requirements.

Indeed, the Federal Reserve has been lowering average requirements over the last twenty years. Since 1953, requirements on net demand deposits have been reduced on balance by about 6 percentage points for both large and small banks. Even taking into account the reserve requirement increases this year, average requirements on time and savings deposits are lower today than twenty years ago. Requirements on savings deposits are at their statutory 3 percent minimum.

In summary, the Fed's argument is this: state laws governing reserves of nonmember banks give them a competitive advantage over member banks. It is not the reserve percentages themselves that cause the inequity, for in most states reserve percentages are not significantly lower than Federal Reserve requirements. It is rather the form in which state laws permit reserves to be kept—balances with correspondents, including uncollected funds, and sometimes United States Government or even tax-exempt obligations—that gives rise to the unfairness.

The competitive advantage nonmember banks obtain makes membership in the Federal Reserve less attractive to state-chartered banks, complicating the task of the Federal Reserve in controlling deposit growth in the banking system as a whole. In this connection, it is worth emphasizing that the "United States is the only important country" in which commercial banks can choose not to be subject to reserve regulation by the central monetary authority.*

To the extent that imposition of uniform reserve requirements might disrupt long-established competitive patterns, some banks will inevitably be hurt in the short run as others are helped. But the long-run result will be a fairer banking system and a Federal Reserve System better able to control the behavior of money and credit in the economy, a benefit to both banks and their customers alike.

* See George Garvy, "Reserve Requirements Abroad", this *Review* (October 1973), pages 256-62.