Research Department
Federal Reserve
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NOW at the Fed

Federal Reserve Chairman Arthur Burns told the Senate Banking Committee last week that the Federal Reserve supported an Administration bill that would permit depository institutions nationwide to pay interest on consumer checking-type accounts (NOW accounts) and to receive interest on their required reserve balances. He said that the proposed legislation would help solve two problems: "First, the distortions caused by the rather haphazard spread of the payment of interest by depository institutions on transactions balances; and second, the withdrawal of banks from Federal Reserve membership because of a growing sensitivity to the financial costs of membership."

Contents of package

The draft bill authorizes NOW accounts (negotiable orders of withdrawal) for all insured commercial banks, mutual savings banks, savings and loan associations, and credit unions. (The latter could issue both NOWs and share-draft accounts, or SDAs.) These interest-bearing checking accounts would be limited to the use of individuals. The ceiling rate payable on NOWs or SDAs would be set (for a three-year period) by an inter-agency committee at a uniform figure below the bank savings-deposit ceiling rate, currently 5 percent.

In another major innovation, the legislation would impose uniform reserve requirements on NOWs and SDAs for all depository institutions. The Federal Reserve Board of Governors would set these requirements, within specified limits ranging from 3 to 12 percent of deposits. The reserve requirements against NOWs and SDAs would be phased in over a three-year period for those institutions offering NOWs and SDAs which do not now belong to the Fed. The reserves could be held directly with the Federal Reserve, or indirectly with other regulatory institutions for redeposit with the Fed.

The other major feature of the bill involves the authorization of payment of interest on reserve balances, at rates determined by the Federal Reserve Board. However, the aggregate interest paid in any year could not exceed 10 percent of Reserve Banks' net earnings for the previous year, before payment of interest on reserve balances.

NOW expansion

The proposal for interest-bearing checking accounts regularizes a financial trend that has been developing for some time. In Burns' words, "The prohibition on the payment of interest on demand deposits enacted in the 1930's did not actually end such payments; rather it changed their form." Commercial banks have provided individuals with an implicit return on demand accounts in the form of

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free or below-cost services, equivalent to about a 5-percent rate of return on demand deposits. Of course, banks have also provided an implicit return for corporations and governmental units. However, the latter, through their financial sophistication, have long since developed the ability to minimize the balances on which they receive an implicit return—and thus have obtained an explicit return on a large part of their transactions balances through the investment of surplus funds in money-market instruments.

Consumers and small businesses have only recently begun to develop this ability, but they too are now receiving explicit returns on transactions balances, because of all the recent innovations which directly authorize interest payments or at least facilitate shifts between savings and demand accounts. But to take advantage of such opportunities, consumers have to live in New England or certain other special locations, or belong to certain credit unions, or at least have the financial sophistication to handle alternative payments opportunities. The whole process thus has been somewhat haphazard and piecemeal.

How much would consumers benefit from the nationwide adoption of NOWs? The New England evidence suggests that the combination of implicit and explicit payments initially would be much larger than the implicit return consumers now earn on their demand deposits. Eventually, the nation's depository institutions probably would impose service charges in an effort to recover at least part of the costs of offering NOW accounts—and meanwhile they would be under pressure to improve their productivity in order to limit such costs. But over time, consumers might well obtain a higher overall rate of return than they now do, because of the intensified competition for business by depository institutions, and also because of their own growing ability to economize on the use of checks.

What would be the cost of NOWs to financial institutions themselves? Federal Reserve studies indicate that, in the competitive situation likely to arise in the early stages of the new regime, commercial bank pre-tax earnings in the worst transition year could average 5 to 6 percent below the levels otherwise prevailing. But to minimize transition costs, the new legislation limits eligibility for NOWs and SDAs to individuals; altogether, the volume of demand deposits convertible to such accounts probably amounts to $80 billion or so, compared to the roughly $320 billion found in all checking accounts. The legislation would minimize transition costs in other ways too—by requiring that the maximum interest rate payable on NOWs be set initially below the bank savings-rate ceiling, by establishing a range of reserve requirements below that of demand deposits, and by delaying enforcement of the act until one year after enactment.

Membership decline

Minimizing the costs of NOWs is especially important for Federal Reserve member banks, many of which have begun to leave the

System to avoid the financial burden of membership. Withdrawals mainly reflect the high cost of non-interest earning reserves that member banks (unlike nonmembers) are required to hold. Over the past eight years, 520 banks have left the System, some because of mergers but most because of outright withdrawals. The remaining members are generally the larger banks, so that members as a group account for 73 percent of total commercial-bank deposits. (Still, their share was 88 percent a quarter-century ago.) There is little reason for optimism in today's environment, because withdrawals have been especially heavy in the area offering NOW accounts (New England), with competitive pressures forcing large as well as small banks out of the System at a rapid pace. The Fed thus argues for the necessity of combining actions to limit the burden of Fed membership with the extension of NOW accounts.

Why should the Fed worry about declining membership? First, a declining proportion of bank deposits at member banks tends to loosen the links between bank reserves and the money supply. This reduces the precision of the central bank's monetary control, especially in view of the wide variations in the relative growth rates of member and nonmember demand deposits. Besides, any attempt the Fed might make to raise reserve requirements as a policy measure could worsen the competitive disadvantage of member banks and prompt further erosion of membership. (That fact helps explain why the Fed is anxious to see reserve requirements imposed on NOWs at all depository institutions.) Again, banks withdrawing from the System lose their direct access to the Fed's discount window, and this could cause a structural weakening of the nation's banking system.

The loss of Fed members could be slowed through the adoption of uniform reserve requirements for all banks, but Congress has consistently rejected that suggestion, despite the recommendations of many official study commissions over the years. Still, the payment of interest on required reserve balances could be a useful step in the right direction. That proposal has met with some resistance in Congress, because the Fed returns virtually all its net revenues to the Treasury, and any reduction in Fed revenues thus means a reduction in Treasury revenues. However, the Treasury might recoup about 55 percent of the amounts paid out, because of the higher income taxes that would be paid by banks and bank stockholders.

In the Fed's view, the proposed 10-percent-of-earnings limitation on interest payouts might not be sufficient to stem the membership decline. Given the System's present level of earnings, that limitation might yield commercial banks no more than $600 million a year. Yet Fed studies indicate that $500 million alone might be needed to offset the present costs of membership, so that little would be left over to alleviate the banks' costs of introducing NOW accounts—or to offset any costs they would incur if the Fed began to charge for its services.

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