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October 5, 1970

Mr. Nat S. Rogers, President
The American Bankers Association
90 Park Avenue
New York, New York 10016

Dear Mr. Rogers:

In further reference to the concern you expressed in your letter of September 2 regarding the Board's recent action on reserve requirements, I am enclosing for your information a staff analysis that I requested before leaving the country for the Fund and Bank meetings in Copenhagen. You will notice that we also heard from Messrs. Donald Graham and A. W. Clausen on the same subject.

I believe you will find that the memorandum addresses itself to the substantive issues raised in your letter, and we thank you once again for communicating to us the views of the American Bankers Association.

Sincerely yours,

Arthur F. Burns

Enclosure

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BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

Office Correspondence

Date October 5, 1970

To Chairman Burns

From The Staff

Subject: Comments on letters received in connection with Board's recent action on Regulation D.

As requested, we have been analyzing during your absence, various comments received on the Board's recent change in reserve requirements, and related views on some broader aspects of monetary policy and regulation. These views were expressed by Messrs. Nat Rogers, Donald Graham, and A. W. Clausen in letters of September 2, 10, and September 21 respectively; and have been considered together since there is some coincidence of subject matter.

The reservations with respect to the Board's recent actions revolve essentially around three points:

(1) The belief that the treatment as demand deposits of less than 30-day holding company paper, and the extension of Regulations D and Q to term debt in the two to seven year maturity range unfairly exclude banks from raising funds in market sectors to which other participants have access.

(2) The belief that the Board seriously underestimated the added burden on banks created by shifting from the originally proposed 10 per cent reserve requirement for all bank-related commercial paper to the 17-1/2 per cent requirement for that of less than 30 days maturity.

(3) The belief that the Board should have requested further public comment on the changed proposal before acting on it.

On the first point, the philosophy underlying the Board's action was to make the treatment of bank holding company commercial paper as close as possible to that of large time certificates of deposit. To accomplish this, the 30-day maturity distinction between time and demand deposits was extended to commercial paper. We recognized fully that this action would have the effect of virtually excluding banks with holding companies from access to the very short term commercial paper market (an avenue which has been closed all along to banks not affiliated with holding companies). We also had in mind, however, that commercial banks could continue to operate in the less-than-30-day sector quite effectively through the purchase of Federal funds, Euro-dollars, and the use of short-term Rp's secured by Treasury and Federal agency securities. Furthermore, from the standpoint of competitive advantage, these latter means are not universally available to other market participants.

In addition, with the Board's previous suspension of rate ceilings on large CD's in the 30-89 day maturity range, banks again have access to this alternative source of funds. And, of course, bank-related commercial paper in this maturity range carries a 5 per cent reserve requirement (rather than the previously published 10 per cent), and has no rate ceiling either.

On the question of subordinated bank debt, the Board's recent extension (effective June 30, 1970) of the point at which term debt becomes exempt from Regulations Q and D -- from two to seven years -- was supported by the following logic: Only a few banks were using such high-yielding notes of two to three years maturity to lure deposit-type funds away from regular depositary-type claims; but to the extent this was occurring, the effect was a clear circumvention of the regulations. The purpose of the new restriction on promissory notes was to ensure that all banks use the subordinated debt, for bona fide capital purposes and not as a substitute for regular time and savings deposits as a source of essentially short-term deposit-type funds. On the general issue of the application of regulations to banks, it can well be argued that commercial banks should be free -- along with nonbank borrowers -- to seek funds without restriction as to reserve requirements or interest rate ceilings, particularly when banks and nonbank borrowers are competing in similar markets and for the funds of similar investors. But there are differences among institutions. It is where the functions of institutions tend to overlap that the distinctions become blurred and reasonable men come to differ as to the appropriate policy approach. It could be argued, from a highly theoretical point of view, that reserve requirements are not really necessary. Most would accept, however, from a pragmatic and institutional viewpoint, that demand deposits should be subject to such requirements, for monetary control if for no other reason. It then becomes difficult to argue that time deposits, too, should not be subject to some reserve requirement since at least a portion of time deposits take on the characteristics of money in their use and function. But time deposits issued to businesses compete with such instruments as Treasury bills and commercial paper issued by nonbank corporations, which do not bear reserve requirements. Where should the reserve requirement line then be drawn? A decision must be made at some point. We have attempted to draw our lines in such a way as to reduce inequities within the banking system, and to minimize the disparities between banks and other competing institutions to the extent this is compatible with the overall objectives of public economic policy. And these disparities can only be viewed within the context of the whole spectrum of regulation affecting banks and other institutions, recognizing that banks have advantages in some respects (such as interest-free demand deposits) that others do not have.

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In the broadest sense, it might be pointed out that commercial banks will in the future expand as a group only to the extent that the Federal Reserve System adds reserves, and to the extent that they can become more active as financial intermediaries. Once again, suspension of Regulation Q ceilings helps facilitate this role. But there is a finer point to make. While the Board may want to encourage financial intermediation at the expense of direct borrower-lender arrangements not subject to the discipline of intermediaries, it must also take account of the effects of flows among different types of financial institutions.

Turning to the second question of the burden on banks by applying the 17-1/2 per cent reserve requirement on commercial paper of less than 30 days maturity, we simply disagree. Our formal survey in February of this year indicated that less than 20 per cent of outstanding bank-related commercial paper had initial maturities under 30 days. This proportion increased over the spring and summer as expectations of declining rates persuaded borrowers to remain short, and based on informal contacts with major banks, we estimate that the short maturities accounted for 30-40 per cent of total outstandings at the time of the Board's announcement.

One banker commented that if the 17-1/2 per cent reserve requirement were placed against the outstandings of his bank alone at mid-August, the reserve impact would account for nearly all of that which we estimated for the entire system. The maturity distribution at mid-August is not relevant, however, in estimating the reserve impact at the effective date one month later. What is important is whether the banks could shift into other sources of funds during the one-month period provided for adjustment. Another felt that it would not be possible in most cases to replace the short dated maturities as they mature with 31 day or longer paper, especially when customers have need for the short dated maturities and other issuers of commercial paper are not penalized when they issue such short dated paper. Despite this pessimism as to the banks' ability to shift, very substantial adjustments have been reflected in deposits and commercial paper and the cost of such adjustment became less costly as rates declined during the period. Latest preliminary data show that the commercial paper-issuing banks got rid of all but $300 million of their less than 30 day commercial paper between August 12 and September 17, and that there was a more than commensurate increase in time deposits during the same period. The fact that banks have reduced their offering rates for CD's maturing in the 30-89 day maturity range indicates that they had no difficulty in finding CD money during this adjustment period. As a matter of hindsight, we now see preliminary indications that the combination of Federal Reserve actions

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and flows of funds resulted in a net reduction in required reserves of approximately $500 million (we estimated only $350 million at the time the Board acted).

On the third point, that we did not invite further public comment, and that the Board should reconsider its action, we were motivated by two principal factors: first, the net effect of our action was designed to reduce required reserves rather than have a tightening effect; and second, we felt that with the available alternatives for securing very short term funds (Federal funds, Euro-dollars, and Rp's) and the full month adjustment period provided, there would be no severe hardship placed on the banks most affected. In retrospect, we feel that these two results did, in fact, obtain.

THE AMERICAN BANKERS ASSOCIATION 90 PARK AVENUE, NEW YORK, N. Y. 10016

NAT S. ROGERS
PRESIDENT

FIRST CITY NATIONAL BANK
HOUSTON, TEXAS 77001

September 2, 1970

Hon. Arthur F. Burns, Chairman
Board of Governors of the
Federal Reserve System
Washington, D. C. 20250

Dear Mr. Chairman:

Reference is made to the announcement by the Board of Governors of the Federal Reserve System on August 17, 1970, that action had been taken to apply a 5 percent reserve requirement on funds obtained by member banks through the issuance of commercial paper by their affiliates, and at the same time to reduce from 6 to 5 percent the reserves that member banks must hold against time deposits in excess of $5 million.

It is understood that notwithstanding the Board's announcement the actual effect of the Board's action as reflected in its published regulation is to set a 5 percent reserve on commercial paper issued with maturities of more than 30 days and a reserve of 17½ percent for reserve city banks for commercial paper with maturities of 30 days or less.

This result apparently is achieved by amending Regulation D to include commercial paper issued by bank affiliates under the definition of "deposits" and treating commercial paper in the same manner as certificates of deposit and time deposits are treated for reserve purposes, namely, on the basis of maturity dates. However, the regulations are silent on this point, and it does not necessarily follow that the regulations can be interpreted in this manner in the absence of specific provisions in Regulation D. The reference to "demand deposit reserve requirements" accompanying the amendment to Regulation D adds to the confusion in view of the specific reference to a 5 percent reserve in the Board's release to the press on August 17, 1970, and the notice sent to member banks in its district by the Federal Reserve Bank of New York on August 17, 1970, a copy of which is enclosed.

These rates become effective on deposits and commercial paper outstanding in the week beginning September 17, for the reserve computation period beginning October 1. It is stated that changes made in the regulation proposed originally last January raise no new issues or are insignificant as a practical matter. In these circumstances, and in view of the deferral of the effective date until September 17, 1970, the Board finds that further notice and public procedure with respect to the announced regulation are unnecessary and would be contrary to the public interest.

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The action taken by the Board in requiring reserves on funds obtained through commercial paper issued by bank affiliates has a significant impact upon a number of the members of The American Bankers Association, and in our view represents a considerable departure from the action proposed initially on January 29, 1970. The initial proposal would have placed a 10 percent reserve on all commercial paper issued by bank affiliates having a maturity of 1 day or more. The final regulation which places a 17½ percent reserve for reserve city banks on commercial paper with maturities of 30 days or less, even though a reserve of 5 percent is set for paper with maturities over 30 days, places commercial bank affiliates in an untenable competitive position in the commercial paper market. It will not be possible in most cases to replace these short dated maturities as they mature with 31 day or longer paper, especially when customers have need for the short dated maturities and other issuers of commercial paper are not penalized when they issue such short dated paper.

We are concerned with the effect which the reserves on commercial paper will have on overall reserves of the banking system, because while we do not have precise statistical information showing a maturity breakdown of outstanding commercial paper issued by bank affiliates, informal information obtained from a number of commercial banks indicates that one-half or more of the paper issued by their affiliates has maturities of 30 days or less. Under these circumstances, the extension of reserve requirements to bank-related commercial paper which is estimated by the Board, as stated in its announcement, to increase required reserves of the affected member banks by roughly $350 million, may in fact place a much heavier reserve requirement on such banks, and lessen the reduction of required reserves for the banking system as a whole. Thus, the amount of net reserves intended to be released to make funds available in financing housing and State and local governments will not accomplish the objectives announced by the Board.

It is requested that the Board reconsider its action with respect to the required reserves set for bank-related commercial paper, and either reduce such reserves to 5 percent for all such paper having maturities of one day or more (the maturities originally designated in the January, 1970, proposal), or defer the effective date of the changes announced on August 17, 1970, until precise data is developed showing the amount of outstanding bank-related commercial paper with maturities of 30 days or less, and the impact on the required reserves of the member banks involved. In view of the relatively limited number of member banks which will be affected directly by the Board's action requiring reserves on bank-related commercial paper, we believe that further consideration to this matter as we request is justified, and that the

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banks involved are entitled to present their views concerning such action before it becomes effective, as provided for in Section 553 (b) of Title 5, United States Code.

Very truly yours,

Nat S. Rogers

Nat S. Rogers
President

Enclosure

FEDERAL RESERVE BANK
OF NEW YORK

[Circular No. 6589
August 17, 1970]

CHANGES IN RESERVE REQUIREMENTS

—Five Percent Reserve Requirement Established
For Bank-Related Commercial Paper

—Reserve Requirement For Time Deposits Over
$5 Million Reduced From 6 to 5 Percent

*To All Member Banks, and Others Concerned,
in the Second Federal Reserve District:*

Following is the text of a statement issued today by the Board of Governors of the Federal Reserve System:

The Board of Governors of the Federal Reserve System today applied a 5 per cent reserve requirement on funds obtained by member banks through the issuance of commercial paper by their affiliates, and at the same time reduced from 6 to 5 per cent the reserves that member banks must hold against time deposits in excess of $5 million.

Both actions will become effective in the reserve computation period beginning October 1 and will be applicable on such deposits and commercial paper outstanding in the week beginning September 17. This coincides with the beginning of the fall period of seasonal expansion of deposits and required reserves.

The dual action will result in a reduction of required reserves of about $350 million for the banking system as a whole. The extension of reserve requirements to bank-related commercial paper is estimated to increase required reserves of the affected member banks by roughly $350 million. On the other hand, the reduction in reserve requirements against time deposits over $5 million is expected to lower required reserves by some $300 million at banks issuing commercial paper, and by about $400 million at all other member banks.

The greater portion of the net reserves thus released will become available to banks that in the present circumstances might be expected to use a sizable share of the available funds in financing housing and state and local governments.

Both actions of the Board were adopted unanimously.

No change was made in the 3 per cent reserve requirement on a member bank's savings deposits, and time deposits of less than $5 million. Today's action represents the first change in reserve requirements since April 17, 1969, when the Board increased reserves on demand deposits by one-half of one per cent for all member banks.

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(Over)

Since most commercial paper is issued in denominations of $100,000 or more, the extension of reserve requirements to bank-related commercial paper will put instruments of this kind on a substantially equal footing, in terms of reserve requirements, with negotiable certificates of deposit issued by banks.

In imposing reserve requirements on commercial paper issued by bank affiliates, the Board used for the first time the authority contained in the Act of December 23, 1969, which explicitly authorized such action. The reserve requirement will apply to funds obtained by member banks through the issuance of commercial paper or similar obligations by their affiliates.

Presently, about $7.5 billion of bank-related commercial paper is outstanding. Over the past year, the amount of such paper had risen by $5.5 billion.

At the time the new reserve requirements become effective the permission initially granted on November 4, 1969, to the Federal Reserve Banks to waive penalties for reserve deficiencies connected with the application of reserve requirements to subsidiaries' commercial paper will be withdrawn.

In taking this action with respect to bank-related commercial paper, the Board urged member banks and their holding companies to comply with the spirit and purpose as well as the letter of the rules regarding member bank reserve requirements.

Copies of the Supplement to Regulation D, revised to reflect the above changes, will be sent to you shortly. Additional copies of this circular will be furnished upon request.

Alfred Hayes,
President.

October 5, 1970

Mr. A. W. Clausen, President
Bank of America
Bank of America Center
San Francisco, California 94120

Dear Mr. Clausen:

As you know, I was in Copenhagen at the international meetings when your letter of September 21 arrived at my office. I find the comments that you made therein to be most useful and constructive; and their benefit is of the best kind that we can get from members of the Federal Advisory Council.

I am taking the liberty of enclosing a copy of a memorandum I asked our staff to prepare while I was out of the country. As you can see it is addressed primarily to comments received from Messrs. Nat Rogers and Donald Graham, but your letter is similar in may respects. I feel that this memorandum gives an accurate picture of the technical reasoning behind the Board's recent action on reserve requirements.

May I say to you I do agree that we have at times been guilty of ad hoc decisions on matters of monetary and regulatory policy. But having said that, I must defend our actions as reflecting the best judgment of reasonable men at the time and under the circumstances.

Your comment about disintermediation and the commensurate rapid growth in commercial paper makes, in my opinion, a very good point -- one to which we addressed ourselves when Regulation Q ceiling on CD's of 30-89 days maturity were suspended. There is more thought to be given in this area, and our study of rate ceilings continues.

I would not agree that our extension of reserve requirements to commercial paper is a step in the direction of asset reserve requirements, to which I assume you would object on selective credit control grounds. Our objective as explained in the attachment to this letter,

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was in the interest of equitable treatment among all banks, most of which do not have holding companies and cannot issue commercial paper, and must therefore rely on certificates of deposit for funds of this character.

We appreciate your views on the subject of the Federal Home Loan Bank Board decision to allow direct payments. We are aware of the many questions and implications this raises for the entire monetary and payments system, and the Board is giving a high priority to a careful and thorough study of the entire matter.

Finally, please be assured that I share your preference for broad monetary control in preference to the selective approach, and I am hopeful that we can make further progress in this area as time and circumstances permit. The conduct of monetary policy is a challenging and at times frustrating business, but I honestly feel that recent policy has been appropriate, and so far, the performance of the economy in the current adjustment has been about as good as could be achieved given the magnitude of the task.

Thank you once again for sharing with us your important views.

Sincerely yours,

Arthur F. Burns

Enclosure

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GERALD R. FORD LIBRARY

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

Office Correspondence

Date October 5, 1970

To Chairman Burns

From The Staff

Subject: Comments on letters received in connection with Board's recent action on Regulation D.

As requested, we have been analyzing during your absence, various comments received on the Board's recent change in reserve requirements, and related views on some broader aspects of monetary policy and regulation. These views were expressed by Messrs. Nat Rogers, Donald Graham, and A. W. Clausen in letters of September 2, 10, and September 21 respectively; and have been considered together since there is some coincidence of subject matter.

The reservations with respect to the Board's recent actions revolve essentially around three points:

(1) The belief that the treatment as demand deposits of less than 30-day holding company paper, and the extension of Regulations D and Q to term debt in the two to seven year maturity range unfairly exclude banks from raising funds in market sectors to which other participants have access.

(2) The belief that the Board seriously underestimated the added burden on banks created by shifting from the originally proposed 10 per cent reserve requirement for all bank-related commercial paper to the 17-1/2 per cent requirement for that of less than 30 days maturity.

(3) The belief that the Board should have requested further public comment on the changed proposal before acting on it.

On the first point, the philosophy underlying the Board's action was to make the treatment of bank holding company commercial paper as close as possible to that of large time certificates of deposit. To accomplish this, the 30-day maturity distinction between time and demand deposits was extended to commercial paper. We recognized fully that this action would have the effect of virtually excluding banks with holding companies from access to the very short term commercial paper market (an avenue which has been closed all along to banks not affiliated with holding companies). We also had in mind, however, that commercial banks could continue to operate in the less-than-30-day sector quite effectively through the purchase of Federal funds, Euro-dollars, and the use of short-term Rp's secured by Treasury and Federal agency securities. Furthermore, from the standpoint of competitive advantage, these latter means are not universally available to other market participants.

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In addition, with the Board's previous suspension of rate ceilings on large CD's in the 30-89 day maturity range, banks again have access to this alternative source of funds. And, of course, bank-related commercial paper in this maturity range carries a 5 per cent reserve requirement (rather than the previously published 10 per cent), and has no rate ceiling either.

On the question of subordinated bank debt, the Board's recent extension (effective June 30, 1970) of the point at which term debt becomes exempt from Regulations Q and D -- from two to seven years -- was supported by the following logic: Only a few banks were using such high-yielding notes of two to three years maturity to lure deposit-type funds away from regular depositary-type claims; but to the extent this was occurring, the effect was a clear circumvention of the regulations. The purpose of the new restriction on promissory notes was to ensure that all banks use the subordinated debt, for bona fide capital purposes and not as a substitute for regular time and savings deposits as a source of essentially short-term deposit-type funds. On the general issue of the application of regulations to banks, it can well be argued that commercial banks should be free -- along with nonbank borrowers -- to seek funds without restriction as to reserve requirements or interest rate ceilings, particularly when banks and nonbank borrowers are competing in similar markets and for the funds of similar investors. But there are differences among institutions. It is where the functions of institutions tend to overlap that the distinctions become blurred and reasonable men come to differ as to the appropriate policy approach. It could be argued, from a highly theoretical point of view, that reserve requirements are not really necessary. Most would accept, however, from a pragmatic and institutional viewpoint, that demand deposits should be subject to such requirements, for monetary control if for no other reason. It then becomes difficult to argue that time deposits, too, should not be subject to some reserve requirement since at least a portion of time deposits take on the characteristics of money in their use and function. But time deposits issued to businesses compete with such instruments as Treasury bills and commercial paper issued by nonbank corporations, which do not bear reserve requirements. Where should the reserve requirement line then be drawn? A decision must be made at some point. We have attempted to draw our lines in such a way as to reduce inequities within the banking system, and to minimize the disparities between banks and other competing institutions to the extent this is compatible with the overall objectives of public economic policy. And these disparities can only be viewed within the context of the whole spectrum of regulation affecting banks and other institutions, recognizing that banks have advantages in some respects (such as interest-free demand deposits) that others do not have.

In the broadest sense, it might be pointed out that commercial banks will in the future expand as a group only to the extent that the Federal Reserve System adds reserves, and to the extent that they can become more active as financial intermediaries. Once again, suspension of Regulation Q ceilings helps facilitate this role. But there is a finer point to make. While the Board may want to encourage financial intermediation at the expense of direct borrower-lender arrangements not subject to the discipline of intermediaries, it must also take account of the effects of flows among different types of financial institutions.

Turning to the second question of the burden on banks by applying the 17-1/2 per cent reserve requirement on commercial paper of less than 30 days maturity, we simply disagree. Our formal survey in February of this year indicated that less than 20 per cent of outstanding bank-related commercial paper had initial maturities under 30 days. This proportion increased over the spring and summer as expectations of declining rates persuaded borrowers to remain short, and based on informal contacts with major banks, we estimate that the short maturities accounted for 30-40 per cent of total outstandings at the time of the Board's announcement.

One banker commented that if the 17-1/2 per cent reserve requirement were placed against the outstandings of his bank alone at mid-August, the reserve impact would account for nearly all of that which we estimated for the entire system. The maturity distribution at mid-August is not relevant, however, in estimating the reserve impact at the effective date one month later. What is important is whether the banks could shift into other sources of funds during the one-month period provided for adjustment. Another felt that it would not be possible in most cases to replace the short dated maturities as they mature with 31 day or longer paper, especially when customers have need for the short dated maturities and other issuers of commercial paper are not penalized when they issue such short dated paper. Despite this pessimism as to the banks' ability to shift, very substantial adjustments have been reflected in deposits and commercial paper and the cost of such adjustment became less costly as rates declined during the period. Latest preliminary data show that the commercial paper-issuing banks got rid of all but $300 million of their less than 30 day commercial paper between August 12 and September 17, and that there was a more than commensurate increase in time deposits during the same period. The fact that banks have reduced their offering rates for CD's maturing in the 30-89 day maturity range indicates that they had no difficulty in finding CD money during this adjustment period. As a matter of hindsight, we now see preliminary indications that the combination of Federal Reserve actions

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and flows of funds resulted in a net reduction in required reserves of approximately $500 million (we estimated only $350 million at the time the Board acted).

On the third point, that we did not invite further public comment, and that the Board should reconsider its action, we were motivated by two principal factors: first, the net effect of our action was designed to reduce required reserves rather than have a tightening effect; and second, we felt that with the available alternatives for securing very short term funds (Federal funds, Euro-dollars, and Rp's) and the full month adjustment period provided, there would be no severe hardship placed on the banks most affected. In retrospect, we feel that these two results did, in fact, obtain.

GERALD R. FORD LIBRARY

A. W. CLAUSEN
President

September 21, 1970

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

Dear Mr. Chairman:

Your interest in certain views discussed at length at the last meeting of the Federal Advisory Council is appreciated, and I am glad to have an opportunity to comment further. Although we are concerned about some recent policy moves in particular, we are even more concerned about the implications on a long-term basis.

The latest Board action in connection with bank related commercial paper again raises the question of whether we are moving toward a more orderly and equitable system of monetary control or slipping into a further patchwork of ad hoc actions which are neither efficient nor offer long-range solutions but indeed lead instead to more problems in regulation. Traditionally, Federal Reserve regulation of member banks has been assumed to be a sufficient substitute for more specific controls over the entire credit mechanism. While in the past a careful control over this important source of money and credit has efficiently transmitted general policy objectives to the credit creation process, the reduced effectiveness of this system has increasingly become evident in the last five years.

As the need for more restrictive credit regulation in an inflationary environment caused the Federal Reserve to tighten its grip on member banks it actually reduced the growth of member bank-provided credit as generated through traditional deposit creation. The restrictive measures used have encouraged an increasing flow of funds outside the banking system which to a great extent offset the decline in the banking system's ability to extend credit. Certainly the rapid growth in the unregulated commercial paper market and the massive disintermediation during 1969 and early 1970 frustrated the objectives of monetary policy and reduced the Fed's credit control base. Hindsight has shown that commercial paper issued on a nonregulated basis also increases risks in the financial system and poses a serious threat to the financial fabric of this country.

In an effort to offset loss of control the Federal Reserve is then forced to work more vigorously on the relatively shrinking banking segment of the financial system to accomplish its objectives. In short, the end result of these developments is that the Federal Reserve frustrates its own objectives.

BANK OF AMERICA NATIONAL TRUST AND SAVINGS ASSOCIATION · BANK OF AMERICA CENTER · SAN FRANCISCO, CALIFORNIA 94120

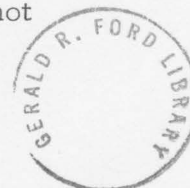
By concentrating its efforts on only one part of the general credit markets, it forces funds into markets beyond its control.

Specifically, we have in mind three recent developments which work in this direction:

1. The use of the Credit Control Act of 1969 to impose reserve requirements on commercial paper is an unprecedented move. It raises questions about the propriety of applying reserves to asset sales of an outright, nonrecourse nature. Presumably the door is now open to the imposition of reserves on assets of any type.

   The primary responsibility of any commercial bank is to meet deposit withdrawals without impairing the safety of funds left by other depositors. This obviously transcends even its obligations to stockholders as a profit-making concern. When faced with net deposit losses under disruptive conditions in financial markets, as in 1966 and again in 1969, it still must provide for the deposit losses in one of two ways: by borrowing or sale of assets. Since borrowing at the Central Bank for any extended period is discouraged, banks thus are faced with the sale of assets to raise the funds necessary. Traditionally bank investment portfolios are utilized for restoring the necessary balance, but this has limits. We all recognize that the sale of securities from bank investment portfolios in an already difficult period would place added pressure on the bond and money markets. Beyond reasonable limits of adjustment it produces a serious impact on the financing of state and local governments. Moreover, it is not clear how sizable capital losses imposed on the banking system can assist monetary authorities who have a responsibility for also maintaining a sound banking system. The outright sale of loans to other investors, however, does provide an orderly transitional outlet for making such adjustments, and bank related commercial paper activities provide this conduit.

   In our judgment the key to monetary control lies in the liability side of the bank statement. We do not quarrel with the necessity for control of the level of credit in the economy, but this is appropriate only through control of the volume of funds available. We do not believe it appropriate for the monetary authorities to attempt to control the asset side where the adjustments have to be made--certainly not to the extent of forcing undue capital losses contributing to disorderly market conditions. The sale of loans facilitated through commercial paper activities by a bank does not by itself affect the ability of the commercial banking system to extend total credit any more than the sale of securities.



This latest move, on bank commercial paper, raises some extremely serious questions regarding the scope and composition of credit regulations. Although the aim of this new regulation is to provide closer control over the credit creation process, its imposition is clearly inequitable. The application of this regulation discriminates against one class of commercial paper issuer without justification for such discrimination. If the issuance of one class of commercial paper can work to frustrate the goal of monetary policy, then the issuance of all commercial paper can have the same result. This latest step alters competitive relationships significantly in favor of nonregulated issuers of commercial paper while encouraging a further slippage in the effectiveness of the Federal Reserve's policies. Several more efficient ways to regulate commercial paper come to mind:

a) require member bank endorsement of all commercial paper thereby bringing all such paper under existing Federal Reserve control.

b) by legislation enact appropriate permanent control of commercial paper issuance giving proper authority to the Federal Reserve system rather than the reliance on such emergency measures as the Credit Control Act.

c) enact the appropriate legislation to bring commercial paper issuers under the Security and Exchange Commission coordinated with Federal Reserve control of the issue volume.

2. A second problem which has received much attention in the last five years is the general use of Regulation Q interest rate ceilings. These have been used both as protective devices and to restrict bank deposit growth. As a device to prevent excessive interest rate competition, their existence in the short-run is necessary. Sharp across-the-board escalation of rates in the thrift area could cause severe earnings problems for many institutions and could lead to imprudent lending and investment practices in order to justify payment. Such practices may, of course, endanger the health of the banking system.

The use of Regulation Q as a credit control device, however, has considerably different implications. We believe it incorrect to view the time deposit market as one homogeneous market. Holders of large certificates of deposit are generally sophisticated investors who are extremely yield conscious. They regard these deposits as money market instruments and are quick to shift to alternate investments at the slightest yield differential advantage. These

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market decisions bear little resemblance to the motives and activities of small savings depositors. Small deposit holders are customarily more concerned with availability and safety than yield. Yet both small deposits and large deposit instruments are currently treated similarly for credit control purposes.

When Regulation Q interest rate ceilings are held below market rates on competing instruments in an effort to moderate bank credit expansion, the differences in the two segments of the time deposit market stand out quite clearly. Funds held in large deposits immediately flow out of the banking system into higher yielding investments. Undeniably, this shift of deposit mix restricts the banking system's ability to create credit and ultimately the tightness in the banking system makes its effects on the economy known. But this proves to be an extremely inefficient and disruptive means to accomplish a modest reduction in the reserve base. Moreover, it causes a significant redistribution of deposits between banks. The net result is simply an increase in velocity which largely offsets the intended tightening for a painfully long time.

It is inequitable to regulate the rate of interest on one investment instrument and leave others free to trade at the market rate. We believe a much better procedure is to recognize that negotiable Certificates of Deposit in excess of $100 thousand, say, are money market instruments and treat them as such. We strongly recommend complete removal of Regulation Q interest rate ceilings on these large CD's. This would allow the banking system to be competitive and keep a greater share of credit transactions within the direct influence of the Federal Reserve System thereby making monetary policy operate more rapidly, more equitably, and more efficiently.

Over the longer term, the viability of Regulation Q ceilings on even small deposits must be questioned. If, as we suspect, the future holds well sustained growth, largely full employment, more capital shortages rather than surpluses, and intermittent inflationary pressures, then the competition for loanable funds will be more and more intense.

Interest rate competition in this sort of an environment would be quite spirited and would reach out to even the smallest saver, with the result that smaller and smaller blocks of funds will become interest sensitive. This implies that the banking system and the Federal Reserve will be faced with fund outflows complicating monetary control and jeopardizing the very banks Regulation Q ceilings were designed to protect.

3. The recent Federal Home Loan Bank Board decision to allow third party payments brings out another aspect of the recurring problem of equity and efficiency in the regulation of competing financial institution. This ruling has effectively granted savings and loan associations the right to pay interest on demand deposits. The ruling as it stands is clearly discriminatory against the banking system and threatens even more dramatic undermining of the Federal Reserve's base of control.

   Ultimately under this ruling a very large proportion of the payments in this country could be handled completely outside the Federal Reserve's control. This cannot but further intensify the rate of decline in the control base and lengthen policy lag to the point where monetary policy would have no significant impact.

   The question arises then whether any financial institution should be permitted to pay interest on demand deposits. What the exact effects of paying interest on demand deposits would be in the modern financial system are unknown. It is obvious, however, that for savings and loan institutions to pay demand deposit interest and for banks not to pay demand deposit interest would be clearly inequitable and undesirable from a public policy point of view. The Federal Reserve's control base would shrink further and banks would be penalized arbitrarily.

   I would hope that you will use your influence to bring about the withdrawal of these amendments by the Home Loan Bank Board. I wholeheartedly endorse the ABA position outlined by Nat Rogers in his letter of September 4. If the Federal Reserve and the commercial banking system are to continue to play the central role in the payments system it is vital now not to encourage the further diversion of payments and transfers into non-reserve channels.

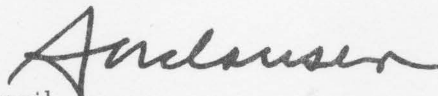
In summary, examples such as those cited serve to underscore the confusing situations created by patchwork control devices and ad hoc regulations. It is imperative that a broader and longer range policy perspective on the part of the Federal Reserve System be adopted. The current excessive regulatory environment fostered by a helter-skelter response to emergency situations must be reformed.

Financial policy decisions designed to influence the course of economic activity can no longer be limited to the context of a banking system. Since this requires some basic alterations in the structure of financial institutions and regulations, it is imperative that further delays in moving in this direction be avoided.

Kindest regards.

GERALD R. FORD LIBRARY

Sincerely,



cc: Members Federal Advisory Council

BANK OF AMERICA NATIONAL TRUST AND SAVINGS ASSOCIATION

October 5, 1970

Mr. Donald M. Graham, Chairman of the Board
Continental Illinois National Bank
and Trust Company of Chicago
Chicago, Illinois 60690

Dear Mr. Graham:

Before I left for the international meetings in Copenhagen, I asked our staff to prepare an analysis of the issues raised in your letter of September 10. I am taking the liberty of enclosing a copy of a memorandum which I think presents an accurate picture of the technical reasons for the Board's August 17 action on Regulation D. You will notice also, the reference to letters received of Messrs. Nat Rogers and A. W. Clausen which contained comments similar to yours.

In general, we appreciate your concern about recent trends in Federal Reserve policy which you describe as being of a selective or direct control nature. While we all have the same basic goals in mind, reasonable men differ on the best means of achieving these ends.

I hope you will recall that shortly after I took this office, I expressed reservations about Regulation Q, and I asked the Board to study the subject carefully; and that the Board's most recent action on Regulation Q was to suspend interest ceilings on large CD's in the 30-89 day maturity range -- surely a start in the direction of which you would approve. And may I also say, that our August action on Regulation D was designed, first and foremost, as a reduction in reserve requirements, in view of the needs of the economy and in view of the fact that most Regulation D changes in the 1960's were increases in reserve requirements.

The treatment of bank holding company commercial papers was done in favor of equitable treatment among all banks and was not meant to deny access to the very short-term market for funds.

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Finally, let me say that while we do not regard monetary policy as perfect, I do feel that we have performed recently to the best of our knowledge and ability under the circumstances; and the response of the economy has been somewhat better than in other post-war periods of adjustment. Please be assured that I share your preference for a broad, general monetary influence over the specific regulatory approach, and it is my personal hope that we can work in that direction as time and circumstances permit.

Thank you once again for sending me your views on these important matters.

Sincerely yours,

Arthur F. Burns

Enclosure

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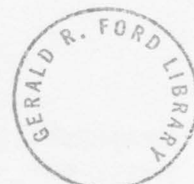
GERALD R. FORD LIBRARY

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

Office Correspondence

Date October 5, 1970

To Chairman Burns

From The Staff

Subject: Comments on letters received in connection with Board's recent action on Regulation D.

As requested, we have been analyzing during your absence, various comments received on the Board's recent change in reserve requirements, and related views on some broader aspects of monetary policy and regulation. These views were expressed by Messrs. Nat Rogers, Donald Graham, and A. W. Clausen in letters of September 2, 10, and September 21 respectively; and have been considered together since there is some coincidence of subject matter.

The reservations with respect to the Board's recent actions revolve essentially around three points:

(1) The belief that the treatment as demand deposits of less than 30-day holding company paper, and the extension of Regulations D and Q to term debt in the two to seven year maturity range unfairly exclude banks from raising funds in market sectors to which other participants have access.

(2) The belief that the Board seriously underestimated the added burden on banks created by shifting from the originally proposed 10 per cent reserve requirement for all bank-related commercial paper to the 17-1/2 per cent requirement for that of less than 30 days maturity.

(3) The belief that the Board should have requested further public comment on the changed proposal before acting on it.

On the first point, the philosophy underlying the Board's action was to make the treatment of bank holding company commercial paper as close as possible to that of large time certificates of deposit. To accomplish this, the 30-day maturity distinction between time and demand deposits was extended to commercial paper. We recognized fully that this action would have the effect of virtually excluding banks with holding companies from access to the very short term commercial paper market (an avenue which has been closed all along to banks not affiliated with holding companies). We also had in mind, however, that commercial banks could continue to operate in the less-than-30-day sector quite effectively through the purchase of Federal funds, Euro-dollars, and the use of short-term Rp's secured by Treasury and Federal agency securities. Furthermore, from the standpoint of competitive advantage, these latter means are not universally available to other market participants.

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In addition, with the Board's previous suspension of rate ceilings on large CD's in the 30-89 day maturity range, banks again have access to this alternative source of funds. And, of course, bank-related commercial paper in this maturity range carries a 5 per cent reserve requirement (rather than the previously published 10 per cent), and has no rate ceiling either.

On the question of subordinated bank debt, the Board's recent extension (effective June 30, 1970) of the point at which term debt becomes exempt from Regulations Q and D -- from two to seven years -- was supported by the following logic: Only a few banks were using such high-yielding notes of two to three years maturity to lure deposit-type funds away from regular depositary-type claims; but to the extent this was occurring, the effect was a clear circumvention of the regulations. The purpose of the new restriction on promissory notes was to ensure that all banks use the subordinated debt, for bona fide capital purposes and not as a substitute for regular time and savings deposits as a source of essentially short-term deposit-type funds. On the general issue of the application of regulations to banks, it can well be argued that commercial banks should be free -- along with nonbank borrowers -- to seek funds without restriction as to reserve requirements or interest rate ceilings, particularly when banks and nonbank borrowers are competing in similar markets and for the funds of similar investors. But there are differences among institutions. It is where the functions of institutions tend to overlap that the distinctions become blurred and reasonable men come to differ as to the appropriate policy approach. It could be argued, from a highly theoretical point of view, that reserve requirements are not really necessary. Most would accept, however, from a pragmatic and institutional viewpoint, that demand deposits should be subject to such requirements, for monetary control if for no other reason. It then becomes difficult to argue that time deposits, too, should not be subject to some reserve requirement since at least a portion of time deposits take on the characteristics of money in their use and function. But time deposits issued to businesses compete with such instruments as Treasury bills and commercial paper issued by nonbank corporations, which do not bear reserve requirements. Where should the reserve requirement line then be drawn? A decision must be made at some point. We have attempted to draw our lines in such a way as to reduce inequities within the banking system, and to minimize the disparities between banks and other competing institutions to the extent this is compatible with the overall objectives of public economic policy. And these disparities can only be viewed within the context of the whole spectrum of regulation affecting banks and other institutions, recognizing that banks have advantages in some respects (such as interest-free demand deposits) that others do not have.

In the broadest sense, it might be pointed out that commercial banks will in the future expand as a group only to the extent that the Federal Reserve System adds reserves, and to the extent that they can become more active as financial intermediaries. Once again, suspension of Regulation Q ceilings helps facilitate this role. But there is a finer point to make. While the Board may want to encourage financial intermediation at the expense of direct borrower-lender arrangements not subject to the discipline of intermediaries, it must also take account of the effects of flows among different types of financial institutions.

Turning to the second question of the burden on banks by applying the 17-1/2 per cent reserve requirement on commercial paper of less than 30 days maturity, we simply disagree. Our formal survey in February of this year indicated that less than 20 per cent of outstanding bank-related commercial paper had initial maturities under 30 days. This proportion increased over the spring and summer as expectations of declining rates persuaded borrowers to remain short, and based on informal contacts with major banks, we estimate that the short maturities accounted for 30-40 per cent of total outstandings at the time of the Board's announcement.

One banker commented that if the 17-1/2 per cent reserve requirement were placed against the outstandings of his bank alone at mid-August, the reserve impact would account for nearly all of that which we estimated for the entire system. The maturity distribution at mid-August is not relevant, however, in estimating the reserve impact at the effective date one month later. What is important is whether the banks could shift into other sources of funds during the one-month period provided for adjustment. Another felt that it would not be possible in most cases to replace the short dated maturities as they mature with 31 day or longer paper, especially when customers have need for the short dated maturities and other issuers of commercial paper are not penalized when they issue such short dated paper. Despite this pessimism as to the banks' ability to shift, very substantial adjustments have been reflected in deposits and commercial paper and the cost of such adjustment became less costly as rates declined during the period. Latest preliminary data show that the commercial paper-issuing banks got rid of all but $300 million of their less than 30 day commercial paper between August 12 and September 17, and that there was a more than commensurate increase in time deposits during the same period. The fact that banks have reduced their offering rates for CD's maturing in the 30-89 day maturity range indicates that they had no difficulty in finding CD money during this adjustment period. As a matter of hindsight, we now see preliminary indications that the combination of Federal Reserve actions

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and flows of funds resulted in a net reduction in required reserves of approximately $500 million (we estimated only $350 million at the time the Board acted).

On the third point, that we did not invite further public comment, and that the Board should reconsider its action, we were motivated by two principal factors: first, the net effect of our action was designed to reduce required reserves rather than have a tightening effect; and second, we felt that with the available alternatives for securing very short term funds (Federal funds, Euro-dollars, and Rp's) and the full month adjustment period provided, there would be no severe hardship placed on the banks most affected. In retrospect, we feel that these two results did, in fact, obtain.

CONTINENTAL ILLINOIS NATIONAL BANK
AND TRUST COMPANY OF CHICAGO
CHICAGO, ILLINOIS 60690

DONALD M. GRAHAM
CHAIRMAN OF THE BOARD

September 10, 1970

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

Dear Chairman Burns:

Over the past year, we have addressed several formal comments to the Board concerning various policy moves of a selective or direct control nature. In addition, several officers of the Continental Bank have made comments to various Board members and to a number of Federal Reserve Bank presidents concerning the trend of Federal Reserve policy. We expressed our deep concern with the apparent moves of the Board increasingly to rely upon direct specific controls with consequent lesser reliance upon general policy prescriptions.

In case you are not aware of these particular points of view, I am enclosing two memoranda to the Board of Governors that we submitted in response to requests for comments on the Board's proposed amendments to both Regulation Q and Regulation D. We feel that the general philosophy spelled out in these memoranda is still pertinent to the present situation. In brief, some of these steps in our judgment introduce harmful discontinuities in the credit markets without in any way changing the Board's control of the total money supply. They tend to encourage the flow of short-term credit through non-bank channels thus penalizing banks unfairly and reducing the Board's influence on credit markets.

The purpose of this letter and the enclosed prior statements is to protest the recent action of the Board to place reserve requirements on the issuance of bank holding company commercial paper. We find objectionable those elements of the regulation which classify such paper of under 30 days' maturity as demand deposits and extend the thrust of the regulation beyond conventional commercial paper maturities to term debt of as much as seven years' maturity. The initiation of these sweeping

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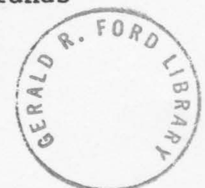
The Honorable Arthur F. Burns
Chairman, Board of Governors
of the Federal Reserve System
Washington, D. C. 20551

September 10, 1970

policy changes without the benefit of public comment is particularly startling.

We feel that this recent move represents a major further, and to us adverse, development of Federal Reserve policy. We are especially concerned with the abrupt manner in which the significance of these moves is dismissed in your release to the press. For example, we would take strong exception to the statement that "expansion of the categories of affiliates subject to the regulations and shifting from the proposed 10% reserve requirement on obligations with a maturity of less than 30 days to the usual demand deposit reserve requirement raises no new issues." The inaccuracy is apparent in the statements accompanying the press release which estimate the shifts in reserve requirements involved in the simultaneous reduction of reserve requirements against time deposits and the application of reserve requirements to bank-related commercial paper. The substance of your press release indicates that the member banks issuing commercial paper would have experienced an increase in their required reserves -- in total -- of some $50 million. In looking at our situation alone, you will be interested that if the new regulation had been applied to our holdings of commercial paper and time deposits over the most recent 4-week reporting period ending 8-12-70, the additional required reserves resulting from the new regulation (including the benefits from the reduction in time deposit reserve requirements) would have averaged about $46 million. The new regulation -- even with the reduction in required reserves on time deposits -- results in higher required reserves for our bank than if the initial regulation calling for a 10% reserve had been adopted.

The new regulation represents a major change in money center banks' method and degree of participation in the short-term money market. The result of this regulation will be to exclude commercial banks from the major segment of this market, which is a major source of funds today for non-financial corporations, the Federal government and its agencies, and non-bank financial institutions. Thus, our only access to short-term money will be through Federal funds, the Eurodollar markets, and repurchase agreements on Treasury and Agency securities. It has been our experience, especially during the recent tight money period, that the bulk of corporate funds seeking temporary employment has resided in the under-30-day area. Many of these funds



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

September 10, 1970

are earmarked for specific purposes and cannot be shifted out into longer maturities. Thus, often it is not merely a question of rate -- it is a question of the transactions' purposes for which the funds are earmarked. This means that the new regulation effectively excludes only banks from this area of the market. We do not understand why the Board again chooses to leave this market to all other corporate and governmental borrowers and intermediaries, especially the unregulated, uncontrolled non-bank commercial paper houses and finance companies which are direct competitors of banks. Our basic protest concerning this particular approach has been set forth at some length in the accompanying documents.

The Board's explanation of its recent action goes on to state that "the increase in the obligations covered as a result of expanding the maturity element from two to seven years is also insignificant since few, if any, obligations have a maturity of two years or more." Again, there is the assumption that this particular change is of no importance to the banking system. If commercial banks are to expand in the 1970s and adequately perform in their role as financial intermediaries, they will of necessity have to tap many new sources of funds. As you well know, the demand deposit route, with the possibility of further conversion of assets, is not likely to offer a net source of appreciable new funds for commercial banks in the 1970s.

The regulation implies that since banks or bank holding companies have not used 5-year notes, for example, that they would never have an interest in tapping this particular intermediate sector of the funds market. Yet this area might very well offer an attractive source of funds for commercial banks. In recent years, many non-bank financial institutions and non-financial corporations, not to mention the Federal government and its agencies, have drawn heavily on such medium-term borrowings. This is understandable in the light of relatively high rates of inflation and congested long-term bond markets. From a regulatory agency's point of view, it would seem to be a proper area in which banks might restructure somewhat the very short-term maturity nature of their purchased funds portfolios. We do not see how the public interest is served by requiring banks, directly or through holding companies, to borrow funds solely at

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

September 10, 1970

the very short or relatively long ends of the maturity spectrum.

The Board's release then goes on to state that "in these circumstances, and in view of the defferal of the effective date until September 17, 1970, the Board finds that further notice and public procedure with respect to the amendments are unnecessary and would be contrary to the public interest." This statement implies that the Board regards the issues here to be of negligible significance or mistakenly ones in which there is general agreement within the financial community. In both the short run and the long run, we feel that the public interest has not been served by these recent additions to the Federal Reserve's already overburdened set of selective controls. In view of the above objections, we strongly urge reconsideration of these moves.

Sincerely

Donald M. Graham

CONTINENTAL ILLINOIS NATIONAL BANK AND TRUST COMPANY OF CHICAGO

November 24, 1969

COPY

Mr. Robert C. Holland
Secretary of the Board of Governors of the
Federal Reserve System
Federal Reserve Building
Washington, D. C. 20551

Dear Bob:

I am pleased to submit a memorandum embodying our views with respect to the proposed amendment to Regulation Q released by the Board of Governors of the Federal Reserve System on October 29, 1969.

Sufficient copies of the memorandum are enclosed so that they will be available to each of the members of the Board of Governors, as well as the staff.

Sincerely,

Donald M. Graham

COMMENTS OF CONTINENTAL ILLINOIS NATIONAL BANK AND TRUST COMPANY OF CHICAGO ON PROPOSED AMENDMENT TO REGULATION Q

The Federal Reserve Board's proposed amendment to Regulation Q to include within the definition of "deposits" of a member bank the commercial paper issued by bank holding companies has provoked major objections from our point of view. We realize that from the Board's point of view the present overall economic climate is such that monetary and credit policy must function properly -- and expeditiously -- to slow the inflationary thrust of our economy. We have no quarrel with the Board's general posture of prolonged, severe restriction. On the contrary, we feel the present level of restraint must be maintained even at the risk of precipitating a more than desired dampening of the economy. In our opinion, the proposed amendment should be viewed as only one of a series of moves which in sum are discriminatory and not productive of the end results desired by the monetary authorities. We believe there are alternative approaches which would achieve better, or at least equal, results without the long-run dangers that are implicit in the recent series of specific, direct controls which have been promulgated.

In this memorandum, we will summarize our objections to (1) the proposed regulation on legal grounds, (2) the specific proposal affecting bank holding company commercial paper, and (3) the general approach used by the Board to effectuate its restrictive policy through the commercial banking system. Finally, we will attempt to suggest some alternative ways that may be used by the Federal Reserve in dealing with the very difficult problems faced by it and the commercial banking system.

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In offering these comments, we realize that the Board and its staff are already

aware of some of these points of view and have heard some of the objections many times before. In our view, however, these observations are important and perhaps crucial to central banking as well as to commercial banking. The arguments bear repeating, and we would like to add our weight to the similar position put forth by others.

Definition of "Deposit" - Our concern in the area involving the legal basis for the Board's proposed action is based on a longer run concern we have over the Board's use and interpretation of the term "deposit." We expressed reservation over this tendency in our letter to the Board of July 28, 1969 in which we commented on the Board's proposed program to implement reserve requirements against bank liabilities to their own foreign branches. We stated then that "we have some concern over an apparent change in the Federal Reserve's approach to the use of reserve requirements as a tool of monetary policy. The application of reserve requirements in this instance involves the asset rather than deposit side of the balance sheet. If this change in approach sets a precedent or indicates a trend for Federal Reserve policy, we feel this approach should be examined carefully before its adoption."

The most substantial difficulty with the proposed amendment appears to be in the need to accept the idea that there is a bank "deposit" in a situation where the bank incurs no liability to anyone else. In the typical transaction which would be covered by the proposed amendment, the holding company issues short-term paper and the bank then sells a portion of its assets (in the form of a participation in loans) without recourse to the holding company. No funds are placed in the bank subject to withdrawal or repayment on demand or otherwise.

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The standard conception of a "deposit" as involving a debtor-creditor relationship between the bank and a depositor seems to have been carried over into virtually every legal context in which the term is used. Section 3(e) of the Federal Deposit Insurance Act, for example, contains an extended definition of the term "deposit" encompassing many different types of relationships and arrangements, all of which, however, share the characteristic of entailing the holding of funds by the bank on someone else's behalf or an immediate or future obligation on the part of the bank to some other person.

The Federal Reserve Board in its many rulings under Regulations Q and D appears never before to have contended that a "deposit" has been created in a situation where the bank incurs no liability. In a 1968 Ruling determining that so-called "dealer's reserves" (which involves certain potential liabilities on the part of a bank) do not constitute "deposits," the Board stated:

> "For the purposes of Section 19 of the Federal Reserve Act and Federal Reserve Regulation D the Board considers that <u>a deposit liability exists only when there is an indebtedness on the part of the bank with respect to either funds received or credit extended by the bank,</u> and that 'indebtedness' for this purpose does not include a contigent liability of the kind represented by a dealer's reserve or differential account. A similar contingent liability that does not constitute such an indebtedness arises in connection with a commitment to make a loan."
>
> 1968 Federal Reserve Bulletin 761 (Emphasis added)

Perhaps, the most controversial previous interpretation by the Board of the term "deposit" has been the amendment of Regulations D and Q in September 1966 to

cover short-term notes issued by a bank. Such notes obviously represent bank liabilities, and the question was whether the term "deposit" is limited to certain kinds of liabilities. The Comptroller of the Currency initially took the view that such notes were not the kind of liabilities deemed to be "deposits" subject to reserve requirements and interest rate limitations; however, he acceded to the Federal Reserve Board's contrary views after the Board amended its Regulations. See Ruling of the Comptroller of the Currency No. 7530 (amended as of June, 1967). This cannot be regarded as a precedent for the present amendment since a liability on the part of the bank (although arguably not a "deposit liability") was created.

The only possible basis for saying that the holding company transactions entail a liability on the part of the bank would seem to be an argument that since the bank and the holding company are under common control, the loan participations may at any time be repurchased by the bank, constituting a "withdrawal" of funds by the holding company. The Board, however, has not stated its proposed amendment in these terms; it has not tried to argue that the arrangement involves liabilities on the part of the bank, but rather that "deposits" of the bank include what are concededly liabilities not of the bank but of the holding company. In any event, the argument lacks validity since the bank has no legal obligation to repurchase participations, and there is no reason whatsoever to expect that such repurchases will be made.

In sum, therefore, the proposed amendment of Regulation Q constitutes a construction of the term "deposit" which is unprecedented and contrary to the universally accepted conception of the term as entailing an obligation to some other person on the part of the bank.

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In short, it appears that the Board has attempted to extend the term "deposit" beyond any meaning of the term which has ever before been suggested and, therefore, beyond any meaning which Congress could have had in mind in adopting Section 19 of the Federal Reserve Act.

Our general concern in this area is the tendency of the Board to interpret the Federal Reserve Act in such a manner as to move into new areas of control over the banking system that we feel are questionable. We do not subscribe to the "ends justify any means" approach that appears to be implicit in recent Board action. Over the years, the working relationship between the central bank and commercial banks has been too valuable to the American economy to be undermined by questionable interpretations responsive to the demands of expediency.

Restriction of Bank Holding Company Commercial Paper - The most obvious objection to the proposed regulation involves singling out the commercial banks for control from the huge over-$30 billion commercial paper market. The tremendous growth of this market in the past year reveals quite clearly the route taken by many of the funds formerly intermediated by the commercial banks via the C/D route. The paper route has offered the most economical and efficient mechanism available to the corporation to continue its expenditure program. Many, turned down at the bank or appalled by the corporate bond market, turned to this avenue to obtain funds. Acting just like commercial banks, they have borrowed short-term funds to place long term -- some undoubtedly in brick and mortar -- all this outside the control of the Federal Reserve System. The commercial banks, seeking a lower cost for their raw material, appeared in this market through their holding companies and began to bid for the same funds. With a given supply, this action served to

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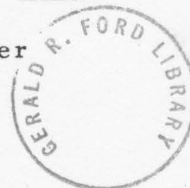
drive these rates up closer to other market rates which used to be the way one would expect such a system to work. These were not new funds; the banks merely channeled them rather than their corporate customers. It can be argued that this process came a step closer to Federal Reserve control at this juncture.

It is sometimes urged that the commercial banks provide a more efficient mechanism to channel a given amount of funds through the economy, and thus the intermediation process outside the banks with its inefficiencies and frictions acts as more of a drag on the economy with resultant greater restriction. If this position is accurate and measurable, it is also probably of marginal significance which could be easily offset by general Federal Reserve restriction of reserve availability. Certainly, the portion accounted for by the banks would be more readily measurable and subject to close Federal Reserve control. The unfettered nature of the market (beyond Federal Reserve control) has been dramatically illustrated by company after company, large and small, moving into this market to obtain funds. In some of these cases, the operation will probably prove efficient enough so that banks have lost their role as a financial intermediary for a significant portion of the business of these companies. A related concern is the question of credit quality. It seems clear that credit extended through this unregulated market has less -- if any -- regulation by the monetary authorities. At the same time, it seems equally clear that banks are better equipped by training and being subject to examination to extend the credit on a sounder basis.

In terms of achieving the Federal Reserve's goal of restricting the growth of total credit in the economy, limitation of bank competition in the commercial paper market does not make sense. The problem of attaining credibility for the


GERALD R. FORD LIBRARY

Federal Reserve's program of monetary restraint is attributable in large part to the availability of an unfettered commercial paper market. Most banks have finally gotten the message but apparently not the entire business community. Is this really so surprising if there is an attractive alternative financing route available to the corporation when its credit requests are declined or scaled down at its banks? For many corporations, the paper route has proven a very economical alternative over recent months.

If the Board acts to close the access of the commercial banks to the nation's money market by foreclosing the use of commercial paper, the action could precipitate some wide-spread difficulties for the financial community. The change that would occur in the banking system would be analogous to that occurring when the Board applied price controls through the use of Regulation Q on bank certificates of deposit. Given continued Federal Reserve monetary restriction, banks will seek the needed funds elsewhere. The larger banks, of course, would again turn to the Eurodollar market, but further reliance upon the cushioning characteristics of this market at the present time would prove difficult. The effect on Eurodollar rates caused by the Board's announcement of October 29 is already apparent. If the Board's proposed amendment should become effective, the Eurodollar borrowings of banks having access to this market would drive rates up quite rapidly over the short run, with possible difficulties ensuing for Western European nations.

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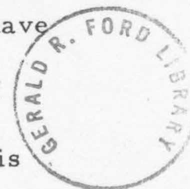
In part, the difficulties might arise because of the very short maturity structure of presently outstanding bank commercial paper. Based on our average maturities, and what we know of other large banks' activities, we doubt that average maturities are much over thirty days. Thus the run-off adjustment process would be more

abrupt than that occurring during the C/D decline. When financial markets are as close to crisis conditions as they are today, the prospect of sudden shifts of this character cannot be treated lightly, even though theoretically over time the funds will merely flow through different channels given no change in the Federal Reserve's posture.

Thus for the large money center banks with branches in London, an alternative source of funds would be available but only at very high cost with disruptive effects on world money markets and a resultant further squeeze on these banks' already sharply declining profit positions.

For other banks, however -- both large and small -- even this unattractive alternative does not exist. For those banks without London branches, the access to the Eurodollar market is, of course, quite limited. Some funds can be borrowed from this market through brokers but this is even more expensive and the volume available is restricted by the individual bank's borrowing limits. In terms of overall equity then, the banks without London branches would again be back in the unfortunate position they were in following their C/D runoff experience. Many medium-sized and even some large banks without London branches were placed in a very difficult position because they had built up their C/D totals and maturities in much the same fashion as the money center banks but did not have the Eurodollar cushion to fall back upon. Now many banks will again be in this position as well as many smaller banks which have only recently become quite tight but which have also at the same time come to rely upon commercial paper for funds. Some of these banks will find it difficult to adjust readily to other sources of funds. It is not generally appreciated that activity in this market is widespread as opposed to



the concentration of Eurodollar volume in the hands of only a few large banks.

General Observations on Board's Policy Techniques - In examining the possible responses of the banking system to the latest in a series of direct control devices, the analysis and terminology used are often put in terms of the banks seeking ways in which to evade Federal Reserve control. The press in general, and financial writers in particular, refer to the Federal Reserve's actions as closing "loopholes" to general credit restraint. Looking at individual banks' actions over the past year, there is probably some validity in this generalization. Under present circumstances, however, it is our observation that commercial banks in general have gotten the Federal Reserve's message of restriction and, consequently, are not desperately seeking funds in this market or any other market with the aim of putting new loans on the books. Commercial banks are now simply struggling to carry their present assets by using the best markets available. A glance at the growth in total bank credit over recent months or even more particularly at business loans does not lend credence to the "loophole theory." The money position manager of a large bank has available several different alternative sources of funds and does not seize upon availability in any particular market as a way in which to add to the bank's loans or other assets. Rather, in these times, any availability of funds at attractive rates in any market is used quite simply and directly to reduce reliance upon high-cost funds in one of the other markets. A glance at the cost of funds in any bank today will quickly reveal the necessity of reducing the marginal cost.

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With the Federal Reserve in full overall control of the reserve base and thus eventually of the total volume of bank credit, a preferable way to look at banks'

efforts to obtain funds in new and varied markets is that this is simply the way that banks as part of a free market system respond to direct price controls. Even if there were an absolute dollar ceiling on total bank credit, those individual banks who sought to maximize profits would still seek funds from the most desirable source. Over the past few months, this would have meant that banks would have entered the commercial paper market just as they have done without any such limitations. Looking at the figures in retrospect, the period has worked out as if they had been operating under such restriction.

What happens in practice then is that if the Board's regulation is aimed at a further restriction of credit availability, it will not achieve this objective. It will, however, adversely affect particular banks in other ways. But is this the proper function of a central bank? For many banks, the major result will be decreased bank profitability coupled with relatively little impact on the banks' demand or usage of funds; in the long run, this kind of move could have serious adverse effects on the banking system.

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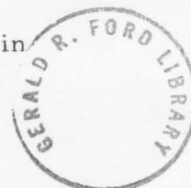
The long-run trend is already all too clear and is the familiar situation of any system of price controls. Each new control breeds an additional control which is followed by the markets' efforts to seek new sources of funds and new approaches to obtain funds followed by further control with a resultant unfortunate cumulative process. These discriminatory aspects appear when commercial banks are prohibited from competing to seek their share of the available supply of funds. This kind of situation is all the more disturbing to commercial banks when other developments in the economy are moving counter to the restriction placed on the banking system. The most obvious example of this, of course, is the existence

of an inadequate fiscal policy during a period of inflation. More specifically, however, it is incongruous to see commercial banks squeezed at the same time that the Federal Home Loan Board announces a reduction in the liquidity requirements of saving and loan associations to free some $650 million for their use. This is another example of the abuses that occur in the resource allocative process when improper Federal economic policy places an undue burden upon one arm of that policy -- credit and monetary policy.

The result has been that the Federal Reserve has been unwilling to place complete reliance upon traditional methods of monetary control. As fiscal policy has failed, and as timing difficulties in monetary policy have appeared, the various aforementioned direct control devices have been made effective. Unfortunately, this has been a relatively simple accomplishment because the commercial banking system is so highly susceptible to such control. As the total economy fails to respond promptly to efforts to curb inflation, more and more pressure is placed on the banking system. Those institutions, both financial and non-financial, outside of the central banking-commercial banking sphere play an increasing role in meeting the nation's financial requirements. In effect, this means that the policy base against which the Federal Reserve reacts has become relatively smaller and smaller. The monetary authorities have obviously concluded that this smaller base can be controlled quite simply by directive -- and this is the path being taken.

Thus it appears in the short run to the Federal Reserve officials that there is ample justification for direct controls over banks to meet what appears to them to be the recalcitrance of these institutions as they constantly plumb for new "loopholes" in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the Federal Reserve's armor. This is the way in which a free market reacts.

The long-run implications of such a process, however, for the commercial banks and for central banking and the market system as well are disturbing. There is the ever present danger that when current pressures cease to exist, there will not be a return to the relatively free market conditions enjoyed previously and continued reliance upon general Federal Reserve techniques of control. In short, we are worried about the long-run interrelationship into which the central bank and commercial banks seem to be entering.

Alternative Approaches - If credit and monetary policy is to have a desirable effect upon the economy through the eventual dampening of inflation, it must be accomplished through changes in total credit availability and in cost. Most of the furor over Federal Reserve policy in recent months arises from its efforts which affect individual institutions, distort money markets, and cause a mammoth reshuffling of the available supply of funds. The entire process may well have produced a higher pattern of interest rates than otherwise would have prevailed and has resulted in the current widespread political criticism without the accompanying rate benefits that have occurred in the past. One overall result is that the financial adjustment process has been hindered. The monetary authorities should no more expect commercial banks to turn off the lending process and show immediate results than they can expect the economy to respond immediately to their policy. (However, in passing it may be noted that the major money center banks have achieved a remarkable result in rationing of credit - with resultant leveling off in loan totals.)

The desirable alternative approach to the various direct control devices attempted is, in reality, quite simple: more reliance upon the traditional quantitative policy measures. There is no new or startling course of action available to Federal Reserve authorities; rather, the sole meaningful alternative is the one which the Federal Reserve knows best how to administer. The only way to return to increased reliance upon the traditional methods of control is to remove the ceiling limitations of Regulation Q. Initially, perhaps the ceiling should be removed only on large denomination C/Ds - perhaps on denominations of $500,000 and over. The argument involving the vulnerability of other savings-type institutions to such changes in Regulation Q no longer carries the weight of former years since market instruments, not commercial bank deposits, have become their main competition. This prescription is one leading toward greater reliance upon the marketplace and upon general techniques of credit control. It is deceptively simple and will meet resistance from those who feel that further tinkering with and adjusting of the economic system must be attempted; but we feel it has a better chance of working in the long run.

Admittedly, the Federal Reserve would have a difficult problem of credibility if they removed Regulation Q ceilings. If this is essentially a problem of communication, it would seem that under present crisis conditions the Federal Reserve System should abandon its time-honored techniques of having very little to say about its policy moves. Strong effort would be required to communicate the basis of such a move to financial markets, to Congress, and to the public at large. The financial markets could be made believers very quickly through the use of the Federal Reserve's traditional techniques. Interest rate barometers would continue to indicate a high degree of restraint as the C/D rate would not just move - in today's markets--to the 7% area but rather would move rapidly to seek an

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adjustment level along with Federal Funds and Eurodollars in the 9%--10% or higher range. Commercial banks would not suddenly obtain quantities of cheap money. Enough profit motives are now being affected by such rate levels that rates again would begin to assume more significance in the plans and projections of bankers as well as others in the financial community. The implementation of such a radical departure in Federal Reserve policy could be accompanied by other techniques such as increases in reserve requirements and the establishment of various C/D bases at various rate levels, but such changes would probably clutter up the objectives of such a program. The crux of the matter would be to free markets--yet to maintain the credibility of Federal Reserve determination to curb inflation. We believe this can be accomplished.

Donald M. Graham, Chairman of the
Board of Directors

November 24, 1969

WALL STREET JOURNAL 11-3-69

The Paper Problem

The more you consider it, the more confusing bank regulation seems. The latest example is the Federal Reserve Board's proposal to apply interest rate ceilings to the short-term unsecured notes, known as commercial paper, sold by one-bank holding companies.

One-bank holding firms themselves are largely a result of excessive regulation. Since banks are often forbidden to expand even into cloesly related financial operations, many of them have formed holding companies. The banks become subsidiaries of the companies, which then can expand into activities barred to the banks themselves.

That is strange enough, but things are getting stranger: The Federal Reserve System for some time has been restricting the banks' reserves as it tries to check inflation. At the same time it has been enforcing ceilings on the interest rates banks can pay on time deposits, including savings accounts.

One alleged purpose of such ceilings is to guard the banks' solvency—in other words, to keep them from paying rates higher than they can afford. But some banks can afford to pay higher rates than others; if protection of solvency is inadequate, better supervision would appear to be a better answer.

Another purpose of the ceilings recently has been to keep banks from bidding funds away from savings and loan associations. This purpose may to some extent have been achieved; if so, it has been at the price of depriving savers of benefits of the generally higher interest rates. In any case, rate ceilings have tended to discourage savings generally, with adverse effects on both the banks and the savings and loan associations.

Still another supposed purpose of the rate ceilings is to aid the anti-inflation effort by limiting the funds banks have to lend. Some one-bank holding companies have been getting around this by selling commercial paper at the going market rates and thus raising funds that can be used by their banks. The proposed rate ceilings now would make the holding companies' paper noncompetitive and presumably unsalable.

That would restrict the funds available to banks, all right, but would it really check inflation? Sales of commercial paper don't increase the total amount of loanable funds at all; a lot of paper, in fact, is sold to banks. Donald C. Miller, senior vice president of Chicago's Continental Illinois National Bank & Trust Co., noted that the holding-company competition in the commercial paper market means that other paper-selling companies find it harder to raise funds for expansion—a result that the Federal Reserve supposedly favors.

It's all mighty peculiar. But things always tend to look that way then you start to wander through the bank-regulatory maze.

GERALD R. FORD LIBRARY

February 13, 1970

Mr. Robert C. Holland, Secretary
Board of Governors
of the Federal Reserve System
Federal Reserve Building
Washington, D. C. 20551

Dear Bob:

We are back again with an additional note of protest on your proposed amendments that would have an effect on bank holding company issuance of commercial paper. The more we look at this possibility in the light of current developments both in this market and in the economy, the more we are concerned about your actual application of new regulations. As time has gone on and this market has grown, the discriminatory aspects of applying regulations only to commercial banks in this huge market seems more and more unfair. Furthermore, if the economy is indeed slowing and we are at the threshold of some easing in Federal Reserve policy, it would seem most unfortunate to saddle the commercial banks with an additional expensive regulation at this particular time. It seems to us that during the past few years you have saddled the commercial banking system with enough costly restrictions that you should not have to add further to the burden at this juncture.

You will note that the accompanying memorandum repeats much of what we have said to you before both in writing and verbally and we would refer again to our memorandum of November 24, 1969 which sets forth more fully our objections to the Federal Reserve's general approach to such problems.

If we can provide any additional information or be of further aid on this subject, we would be happy to work with you.

Sincerely

/s/ D. M. Graham

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COMMENTS OF CONTINENTAL ILLINOIS NATIONAL BANK
AND TRUST COMPANY OF CHICAGO ON PROPOSED
AMENDMENT TO REGULATION D

We are taking this opportunity to comment again on the Board's proposed amendment to its Regulation D, "Reserves of Member Banks," applying reserve requirements to bank-related commercial paper. We realize the Board is aware of some of our views expressed hereafter and has heard some of the objections before. Many of the same points were made by us in a memorandum to the Board dated November 24, 1969. We feel they are still valid, however, and bear repeating.

Our main objections to the proposed amendment are (1) it singles out commercial banks for control from the large and growing commercial paper market, and (2) it appears as another in a series of moves by the Board to use direct controls over commercial banks. This approach to control overall credit growth and to channel funds into various sectors of the economy is a disturbing development to us. We feel such steps in the past have not had the desired effect in reducing credit growth and at the same time have reduced the competitive ability of commercial banks.

Applying a 10% reserve requirement on funds obtained by member banks through the issuance of commercial paper would not in itself mean any reduction in the use of this technique as a source of funds. As long as the cost of commercial paper, including required reserves, is less than alternative sources of available funds, the issuance of commercial paper will continue in order for commercial banks to accommodate the needs of customers based on long-standing relationships. To the extent that 10% of the funds obtained through commercial paper issuance is required as reserves, a case can be made that bank holding company paper outstanding would have to be increased in order to maintain the same level of loanable funds. What will happen is that the cost of these funds to commercial banks will be higher

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than for a non-bank issuer of similar paper.

Even if this action were to cause banks to reduce the issuance of commercial paper, it would not necessarily mean any reduction in total credit provided in the economy. The rapid growth of the commercial paper market in the past year reveals quite clearly the route taken by many of the funds usually intermediated by the commercial banks. Issuance of commercial paper has offered the most economical and efficient mechanism available for corporations to obtain funds, particularly since they have not been able to meet their needs by obtaining loans from commercial banks. To the extent commercial banks are forced to cut back further on bank credit growth due to the higher cost of funds obtained through commercial paper issuance, non-financial corporations will be forced to turn to a greater degree to issuing their own commercial paper if they intend to carry out spending programs. This has been the trend throughout 1969. As the commercial banks lost funds because of interest rate limitations, the rise in commercial paper by non-financial corporations accelerated. It is often argued that commercial banking affords a more effective mechanism of intermediation. The record in 1969 indicates little hesitation on the part of corporations to obtain needed funds via non-banking sources such as the commercial paper market.

The action by the Board in this proposed amendment in our view reflects another in a series of moves either to use direct control over banks or increase the cost of funds to banks over what other businesses are required to pay. These actions imply the banks in general are seeking ways to evade Federal Reserve control. Under the present system, however, it is our observation that commercial banks in general have responded to the Federal Reserve's policy of restraint. Consequently, banks are not seeking funds in the commercial paper market or in any

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other market with the aim of putting new loans on the books. Commercial banks are simply struggling to carry their present assets by obtaining funds in available markets at the lowest cost. The record of bank credit growth in 1969 demonstrates this posture. On the other hand, total credit growth in the economy shows the ability of other sources and markets to carry an inflating economy.

The efforts by commercial banks to obtain funds in new and varied markets is simply the way that banks as part of a free market system respond to direct price controls. This has meant that banks have entered the commercial paper market just as they had previously attempted to cushion the effect of declining time and savings deposits by entering the Eurodollar market. Despite these shifts to new markets, total bank credit in the last year has shown very little growth as would be expected in response to the Federal Reserve policy of tight restraint. What has happened, however, is that an increasing amount of financing is now being done outside the commercial banking system and, therefore, outside of the direct influence of the Federal Reserve System.

The long-term trend of these types of actions is disturbing. As banks attempted to cushion the impact of large and discrete losses caused by unrealistic interest rate limitations on deposits, the Board has felt the need to apply additional controls. This leads to the question of what will happen in the future. If the move is taken to apply reserve requirements to commercial paper, will the next step be to make these funds subject to Regulation Q and effectively restrict their issuance under current money market conditions? Increasing controls, through effectively stopping banks from attracting funds in some markets or increasing the cost so as to reduce profitability, could have serious adverse effects on the banking system's long-run future.

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We also feel another aspect of the Federal Reserve's action is to attempt to control the flow of funds. One stated motive for the maintenance of interest rate limitations on time and savings deposits was to protect savings banks and savings and loan institutions from losing funds and thus reducing the availability of funds for mortgages. (Bank entrance into commercial paper has not provided an additional means of disintermediation because of minimum denomination requirements.) This, of course, has not been successful and is reflected in the recent increases in interest rate limits which have probably had only a minimal effect in allowing banks to hold funds. It is our feeling that not only does the Federal Reserve not have the techniques with which to allocate funds to various markets, but it is doubtful whether techniques could be developed without changing the Federal Reserve's traditional role in the Nation's financial structure.

We recognize the possibility that the Board's recent liberalization of Regulation Q may mesh nicely with a declining pattern of interest rates which will gradually and flexibly allow the reentrance of commercial banks into money market areas now effectively excluded. If such projections of lower interest rate trends are wrong, however, (which is not beyond the realm of possibility) then banks could be saddled with sharply higher interest costs of savings and time deposits and on marginal Eurodollars as well as the higher costs resulting from the proposed reserves on bank commercial paper. In the short run, banks would still seek to finance their current needs through utilization of the most desirable fund alternatives. This would mean little change in their demands but would mean a further reduction in profits. In the long run, of course, the theory of the firm would suggest the disappearance of some banks through the working of the competitive process as stylized by the posture of the central bank. We cannot

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believe this to be the goal of the Federal Reserve System, but it is a disturbingly logical conclusion to the direct control techniques recently introduced and furthered by the suggested application of Regulation D.

It should be emphasized that we are not objecting to the Board's general posture of restrictive monetary policy. We agree that the strong inflationary pressures have required the present level of restraint. Recent trends in economic conditions suggest the possibility for some move toward ease within the near future, but the inherent inflationary problem requires the risk of causing more than a desired dampening of the economy. We do not quarrel with the intent of monetary restraint, but rather with the methods used which in our view are discriminatory and nonproductive of the end results desired by the Board.

February 13, 1970

GERALD R. FORD LIBRARY

November 6, 1970

TO: Board of Governors

FROM: Division of Federal Reserve Bank Operations & Office of the Secretary

SUBJECT: Relationship of Federal Reserve System to ABA and other Banking Associations

Recommendation

In view of the fact that membership in the American Bankers Association exposes the Federal Reserve System to charges of possible conflict of interest, participation in political activity, and an improper expenditure of public funds, it is believed the Reserve Banks should consider discontinuing their "membership" relation in favor of the status of the "subscriber to services" if the so-called advantages of the ABA relationship can be maintained. S-1647 dated February 7, 1958, and S-1791 dated May 11, 1961 contain the latest Board policy statements on the general subject of banking association membership dues and contributions. In addition, Mr. Scanlon's letter of May 2, 1969 to the Presidents of the Reserve Banks gives the background out of which Mr. Kimbrel's current assignment grew. (Copy attached.)

Membership by the Federal Reserve Banks in the various state associations is a longer run issue but one which should be considered further. The President's Conference is currently discussing state bankers association relationships, in keeping with the Conference discussion of June 22, 1970. (Copy attached.) Perhaps the entire matter can be discussed with the Reserve Bank Presidents at the afternoon meeting on November 17. Associations such as the AIB, BAI, and Robert Morris Associates are sufficiently different in organization and purpose

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that we see no need to consider withdrawal from membership status in those groups.

Discussion

The following summary shows by district for the year 1969 the total contributions to banking organizations and attached is a detailed listing of organizations by district.

	ABA	State BA's	AIB	Other
Boston	$2,200	$2,305	$2,495	$ 920
New York	2,235	5,240	5,336	678
Philadelphia	2,200	1,960	298	960
Cleveland	2,270	1,627	1,530	932
Richmond	2,270	2,435	3,584	1,118
Atlanta	2,460	2,245	5,628	1,223
Chicago	2,235	950	-	470
St. Louis	2,305	1,898	2,873	1,134
Minneapolis	2,229	1,220	5,876	1,097
Kansas City	2,305	1,425	4,180	945
Dallas	2,305	1,900	3,282	1,205
San Francisco	2,340	1,480	4,888	1,409
	$27,354	$24,685	$39,970	$12,091

The services which the Federal Reserve would presumably want to continue on a pay-as-you-go basis can be broadly categorized as follows:

Educational. Educational facilities of the ABA, such as listed below, have been used extensively and successfully for personnel and management development by the Federal Reserve Banks:

American Institute of Banking
Stonier Graduate School of Banking
National Trust School
National Mortgage School
National Automation School

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Publications. Access to and the use of ABA publications is a means of keeping abreast of developments in commercial banking.

Cooperation. The Federal Reserve and the ABA have a similar objective in aiming their efforts toward strengthing the commercial banking system. Cooperations has contributed materially to the success of the following programs:

Emergency Preparedness
Check Mechanization (MICR)
Discount Mechanism Study
Uniform Designation of Securities (CUSIP)
Business Loan Surveys

Joint responsibility. In addition to mutual cooperation, there is also an area related to the check collection system where there is joint responsibility; assignment of the check routing symbol is the responsibility of the Federal Reserve and the transit number is the responsibility of the ABA.

Economic intelligence. Attendance at national, State, and local meetings permit regional soundings and blending of views that constitute one of the important strengths of the Federal Reserve System.

We believe the ABA leadership is amenable to the recommended change in status, and President Kimbrel feels that the Reserve Bank Presidents will be receptive also. It appears that the benefits described above could continue to accrue to the Federal Reserve System under an alternative arrangement whereby we would pay our share of the cost of

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these benefits but would not be considered "members" or even associate members.

The undesirable political consequences of involvement with the ABA do seem, with one exception, to be of a nature that would disappear or could be more successfully "played down" if actual "membership" were terminated. That one exception has to do with the expenditure of public money. It can be argued that one cannot effectively "trace dollars" and any financial support of the ABA could be construed as an expenditure of the taxpayer's money in support of activities, lobbying or otherwise, with which the Federal Reserve would not wish to be associated. This does not, however, change our recommendations.

Attachments

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FEDERAL RESERVE BANK OF CHICAGO

OFFICE OF THE PRESIDENT

May 2, 1969

To: MEMBERS OF THE CONFERENCE
OF PRESIDENTS

You have most likely received a notice indicating that the American Bankers Association's dues for Federal Reserve Banks and others will be substantially increased effective September 1, 1969. In the circumstances, President Clay has suggested that it would be entirely appropriate for the Presidents' Conference to review the benefits and appropriateness of membership and develop a System posture with respect to such expenditure. While he believes the Federal Reserve Banks should be members of the American Bankers Association, he feels we would be wise to establish the justifications. His purpose in calling attention to consideration of some special rate is prompted by his understanding that the new dues schedule finances the entire program of the ABA and includes a number of items which previously had been handled by special assessments, some of which we have felt were not proper items for Federal Reserve expenditure.

The purpose of this memorandum is to inform you that the matter is being referred to the Committee on Bank Coordination and Special Topics for consideration at the June meeting of the Conference. It would be desirable for each of us to defer payment of the ABA dues on the new basis until after the June meeting.

Sincerely,

Charlie

Charles J. Scanlon
Chairman, Conference of
Presidents

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[Excerpt from Minutes of Conference of Presidents' meeting - June 22, 1970

<u>Membership in State Banking Associations</u>

Mr. Kimbrel reported that on May 6 the Conference Chairman referred to the Committee on Bank Coordination and Special Topics for its consideration, a question raised by the Federal Reserve Bank of Kansas City regarding Reserve Bank memberships in state banking associations. He reported that the Committee had conducted a survey of the Reserve Banks and noted from the returns that a wide disparity exists in the membership dues paid by the various Federal Reserve offices. The Committee, Mr. Kimbrel said, intended to discuss this matter with American Bankers Association staff members who were acquainted with this problem and with officials of the national state banking association managers group with a view to developing a membership arrangement for the Reserve Banks similar to the arrangement made with the ABA. This would be a non-voting membership; it would be a System membership so that where two Banks service parts of a State there would be a single membership between the two Banks; and, membership would be established on a permanent basis, not subject to renegotiation when the individual associations raised their dues schedules.

Several Presidents were of the opinion that membership in the state banking associations had value as a means of communicating and working with banks in their Districts. However, the value of these memberships had to be weighed against the costs involved. Mr. Kimbrel noted that in 1969 the Federal Reserve Banks paid $23,778 for membership in state banking associations.

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The Amount and Breakdown by District of the Total Amount of Dues Paid by the Federal Reserve System to the American Bankers Association, State Bankers Associations, Regional Banking Organizations, Banking Institutes, etc. for the Year 1969

Boston

American Bankers Association	$2,200
Connecticut Bankers Association	750
Maine Bankers Association	200
Massachusetts Bankers Association, Inc.	1,000
New Hampshire Bankers Association	200
Rhode Island Bankers Association	5
Vermont Bankers Association, Inc.	150
American Institute of Banking, Boston Chapter	2,495
Bank Administration Institute	420
Robert Morris Associates	500

New York

American Bankers Association	2,235
American Institute of Banking	5,336
Bank Administration Institute	560
Bank Credit Associates of New York	18
Bank Operations Conference of New York City	75
Connecticut Bankers Association	375
Erie Niagara Counties Bankers Association	-
National Association of Bank Women	25
New Jersey Bankers Association	1,440
New York State Bankers Association	3,300
New York State Bankers Association - Group I	125

Philadelphia

American Bankers Association	2,200
New Jersey Bankers Association	560
Pennsylvania Bankers Association	1,400
American Institute of Banking	298
Bank Administration Institute	
National	400
Philadelphia Chapter	35
Robert Morris Association	
National	460
Philadelphia Chapter	30
Bank Methods - (local organization)	35

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Cleveland

American Bankers Association	$2,270
Ohio Bankers Association	152
American Institute of Banking	1,530
Robert Morris Association	441
Bank Administration Institute	491
Kentucky Bankers Association	500
Pennsylvania Bankers Association	900
West Virginia Bankers Association	75

Richmond

American Bankers Association	2,270
North Carolina Bankers Association	200
North Carolina Bankers Association-Group 9	12
South Carolina Bankers Association	500
Virginia Bankers Association	750
Virginia Bankers Association-Group 2	25
Virginia Bankers Association-Group 3	25
West Virginia Bankers Association	575
Maryland Bankers Association	338
Maryland Bankers Association-Group 7	10
American Institute of Banking	3,584
Association of Agricultural Bankers	15
Bank Administration Institute	595
Bank Administration Institute-Piedmont Chapter	3
Robert Morris Associates	450
Robert Morris Associates-Carolina, Virginias Chapter	55

Atlanta

American Bankers Association	2,460
State Bankers Association	2,245
Bank Administration Institute	655
National Association of Bank Women	75
Robert Morris Associates	493
American Institute of Banking	5,628

Chicago

American Bankers Association	$2,235
Illinois Bankers Association	100
Illinois Bankers Association-Chicago Chapter	430
Indiana Bankers Association	100
Iowa Bankers Association	100
Michigan Bankers Association	
Chicago	100
Detroit	60
Wisconsin Bankers Association	60
Bank Administration Institute	430
Bank Administration Institute	
Chicago Chapter	25
Detroit Conference	15

St. Louis

Missouri Bankers Association	$500
Mortgage Bankers Association of St. Louis	40
Illinois Bankers Association	100
Junior Section Arkansas Bankers Association	10
Arkansas Bankers Association	500
Indiana Bankers Association	100
Bankers Transit Club of Kentuckiana	60
Kentucky Banking Association	500
Tennessee Bankers Association	88
National Association of Bank Women -	
St. Louis	25
Louisville	25
Memphis	25
Robert Morris Associates -	
National (all offices)	445
Southern Chapter (Little Rock)	8
Ohio Valley Chapter (Louisville)	8
Southeast Chapter (Memphis)	8
Bank Administrative Institute -	
St. Louis	410
Little Rock	45
Louisville	80
Memphis	55
American Bankers Association -	
St. Louis	2,200
Little Rock	35
Louisville	35
Memphis	35
American Institute of Banking -	
St. Louis	2,005
Little Rock	575
Memphis	293

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Minneapolis

American Bankers Association -	
Minneapolis	$2,200
Helena	29
Independent Bankers Association	75
Michigan Bankers Association	100
Minnesota Bankers Association	750
South Dakota Bankers Association	50
North Dakota Bankers Association	50
Wisconsin Bankers Association	60
Montana Bankers Association	210
Bank Administration Institute -	
Minneapolis	550
Helena	42
American Institute of Banking -	
Minneapolis Chapter	5,876
Robert Morris Associates	400
Robert Morris Associates -	
Minnesota Chapter	30

Kansas City

American Bankers Association	2,305
Missouri Bankers Association	500
Kansas Bankers Association	375
Colorado Bankers Association	100
Nebraska Bankers Association	50
Wyoming Bankers Association	100
New Mexico Bankers Association	100
Oklahoma Bankers Association	200
American Institute of Banking	4,180
Bank Administration Institute	500
Robert Morris Associates	445

Dallas

American Bankers Association -	
Dallas	2,200
El Paso	35
Houston	35
San Antonio	35
*Texas Bankers Association -	
Dallas	1,000
El Paso	200
Houston	100
San Antonio	200

*Due to receipt of billings, the annual dues for the years 1969 and 1970 were both paid in 1969.

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Dallas (continued)

Arizona Bankers Association -	
Dallas	$50
El Paso	50
Louisiana Bankers Association (Dallas)	100
New Mexico Bankers Association -	
Dallas	50
El Paso	50
Oklahoma Bankers Association (Dallas)	100
Robert Morris Associates-National	415
Robert Morris Associates -	
Texas Chapter (Dallas)	15
El Paso	20
Houston	20
San Antonio	20
Bank Administration Institute -	
Dallas	610
El Paso	37
Houston - Gulf Coast Chapter	30
San Antonio	38
American Institute of Banking -	
Dallas	2,500
El Paso	210
Houston	349
San Antonio	223

San Francisco

Alaska Bankers Association	50
American Bankers Association	2,340
Arizona Bankers Association	100
Bank Administration Institute	610
California Bankers Association	985
Credit Managers Association of Northern & Central California-Bankers Chapter	175
Idaho Bankers Association	-
Los Angeles Credit Mens Association	8
Nevada Bankers Association	75
Oregon Bankers Association	150
Robert Morris Associates	556
Salt Lake City Bank Officers Association	60
Utah Bankers Association	50
Washington Bankers Association	70
American Institute of Banking	4,888

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