The original documents are located in Box B1, folder "American Bankers Association (1)" of the Arthur F. Burns Papers at the Gerald R. Ford Presidential Library.

MONETARY CONFERENCE

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

December 22, 1969

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

Dear Doctor Burns:

We are delighted that your schedule will permit your accepting our invitation to attend and participate on the program of the 1970 American Bankers Association's Monetary Conference to be held at The Homestead, Hot Springs, Virginia, on May 17-20, 1970.

The Program Committee has designed what we think to be an outstanding program and will look forward to your remarks at the noon luncheon on Monday, May 18. The morning session on that day is entitled "The Battle Against Inflation" and will have as one of the speakers Doctor Paul McCracken.

During the afternoon following the luncheon and your remarks, a session entitled "International Liquidity and the Adjustment Mechanism" will take place.

The conferees consist of the Chief Executive Officers of the largest 50 banks in the United States, their counterparts from approximately 30 large European banks, central bankers, and high government officials from major industrial nations.

If there are any questions that you might have, please contact Roy Terwilliger, The American Bankers Association, 90 Park Avenue, New York, New York 10016. Full details concerning the entire program will be forthcoming as the date approaches.

Sincerely yours,

William H. Moore

William H. Moore
Chairman, Conference Committee

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FROM:
THE AMERICAN BANKERS ASSOCIATION
Information Office
815 Connecticut Ave., N.W.
Washington, D.C. 20006 '69

STATEMENT OF POLICY ON H.R. 6778

(Adopted by the Federal Legislative Committee of
The American Bankers Association, February 5, 1970.)

H.R. 6778 was passed by the House of Representatives on November 5, 1969, purportedly to extend Federal regulation of bank holding companies to the approximately 900 companies which own only one bank. In actual fact, however, the bill went considerably further and attempted to define the business of banking. This was done by setting forth a list of activities prohibited for bank holding companies and their subsidiary banks, combined with strong statements of legislative intent to the effect that the prohibition on these activities should be applicable to all banks, whether or not members of holding companies.

There are, of course, certain activities which are not properly related to banking. Banks and bank holding companies should engage only in those activities which are financial in nature or are functionally related to banking or finance. However, the Association is strongly opposed to any measure which would place rigid limits on the banking business. Moreover, we are convinced that the rapidly changing economic environment within which banks operate makes it unrealistic and even dangerous to attempt to define such limits by statute.

It requires only a few seconds' thought to realize what would have happened had government attempted to define banking in terms of, say, the world of 1860. Had this been done, banks would not be in the deposit business today but would still be issuing circulating notes, for hand-to-hand currency, and the public would have been deprived of the ease and convenience of checking account transactions. If such an attempt had been made in the 1920's, a wide variety of banking activities would not be available to the public from banks, such as consumer installment loans or long-term monthly-payment mortgage loans. Even as late as 1960, had there been an attempt to define the banking business in terms of what was then being generally offered to the public, banks undoubtedly would be prevented from offering direct lease financing or issuing multiple-maturity certificates of deposit.

What is functionally or properly related to the business of banking can only be determined in the light of existing circumstances and in reasonable anticipation of future demands on the industry. It cannot and should not be a matter fixed by statute in some kind of "laundry list" of permitted or prohibited activities. Responsibility for determining the scope of bank operations has been placed in the hands of those bank regulatory agencies charged with safeguarding the public interest. This has been true of Federal and State legislation for 150 years. To abandon this principle would be a serious mistake. Accordingly, The American Bankers Association opposes the adoption of H.R. 6778.

The American Bankers Association at this time endorses five basic principles which should be determinative in selecting a reasonable approach to the potentially destructive legislation contemplated by H.R. 6778.

1. We endorse the principle that serious and thoughtful study of the nation's financial system by an appropriate commission is an essential prerequisite to any legislation of the type contemplated by H.R. 6778.

Pending the completion of such a study we believe that the responsible Federal agencies should prevent the expansion of one-bank holding companies into inappropriate activities.

We believe that such a study should recognize that it is in the public interest to have access to broad competition in financial and functionally related services. It should also recognize the demands which will be made upon the banking system in the future and the extent to which banks will require broader access to funds to meet these demands.

Change is proceeding with bewildering rapidity in banking and in other financial industries. The organization of bank holding companies is only a reflection of the fundamental forces affecting all financial institutions, both bank and nonbank. Parallel developments are occurring in other sectors of the economy, as pressures for diversification and additional services increase in intensity.

A decade has passed since the last major study of the financial system, by the Commission on Money and Credit. A new and penetrating look at the structure, functions, and supervision of financial institutions is long overdue. No better evidence of the complexity of the problem or of the need for study is found than in the tortuous history of H.R. 6778, which included long consideration and rejection of numerous proposals and, ultimately, an attempt to write new legislation on the floor of the House itself.

2. We endorse the principle that banks and bank holding companies should be permitted to engage in any activities which are financial in nature, or are functionally related to banking or finance, and that they should be limited to such activities.

We believe that it would be a mistake now, or at any time, to define the term "banking" or the terms "functionally related to banking or finance" or "financial in nature" in precise statutory language. We believe that the Federal regulatory agencies should be authorized to interpret these terms from time to time in the light of changing conditions and circumstances.

3. We endorse the principle that whatever regulation is adopted, temporarily or permanently, for bank holding companies, should apply equally to all such holding companies whether one-bank or multi-bank.

There are identifiable differences between multi-bank and one-bank holding companies, some of which go beyond the matter of expansion through the acquisition of banks. Nevertheless, we believe that here as in other situations the economy is better served when all competitors -- both bank and nonbank -- are subject to the same ground rules.

4. We endorse the principle that holding company legislation whether multi-bank or one-bank should provide only for regulation of the domestic activities of holding companies.

It has been the practice and policy of the Congress and the States for many years to regulate banks under the national banking laws and the state banking laws. It would be a mistake to provide different regulation for banks owned by holding companies from that provided for other banks. It would also be a mistake to restrict foreign activities of American banks or holding companies in any manner which would interfere with their ability to compete effectively outside the United States.

5. We endorse the principle that any legislation finally adopted must make reasonable provisions for activities begun in good faith and in full accordance with existing law and that unfair retroactivity be avoided.

Paper No. 5

January 23, 1970

ANALYSIS OF H.R. 6778

Data Processing

Present Law

Multi-bank holding companies. Under section 4(c)(1)(C) of the Bank Holding Company Act, registered bank holding companies may invest in a company that furnishes services to or performs services for the bank holding company or its banking subsidiaries. And under section 4(c)(5) a registered bank holding company may invest in any company in which a national bank may invest subject to the same restrictions as a national bank. These provisions contain ample authority for registered bank holding companies to maintain data processing subsidiaries.

One bank holding companies: None.

National banks. Under 12 U.S.C. 24(7) national banks may perform any services that are incidental to the banking business. In accordance with this authority, the Comptroller of the Currency has ruled that incidental to its banking services, a national bank may make available its data processing equipment or perform data processing services on such equipment for other banks and bank customers, Comptroller's Manual for National Banks, paragraph 3500.

The Bank Service Corporation Act, 76 Stat. 1132, 12 U.S.C. 1861-1865, permits the establishment of separate corporations by which small banks may combine their resources to purchase data processing equipment.

State banks. Some states have statutes specifically authorizing the performance of data processing services, with greater or lesser restrictions and limitations, while others simply allow state banks to perform such services under the incidental powers clause of the state banking codes.

Proposed Law (H.R. 6778 as adopted by the House of Representatives, November 5, 1969)

All bank holding companies. As enacted by the House of Representatives, H.R. 6778 provides that bank holding companies or subsidiaries thereof cannot engage in the business of providing data processing services except as an incident to banking services such as the preparation of payrolls, or to the extent necessary to make economical use of equipment primarily acquired and used for the bank holding company or its bank subsidiaries.

Banks. While the foregoing language appears to be specifically directed at bank holding companies and subsidiaries of bank holding companies, the sponsors of the amendment indicated during the course of debates that it should also be applicable to banks. Illustrative statements are:

> Representative Patman: I want to make it clear that when the Congress says that the activities listed in section 4(f) of the bank holding company act, as amended by this bill, are neither necessary, incidental or related to banking we mean just that. Therefore, the Comptroller of the Currency, the Federal Reserve Board, the Federal Deposit Insurance Corporation and the courts should take into consideration this statement of legislative policy when considering what is incident to banking under the banking laws.

> Representative Blackburn: I think it is going to be significant in the eyes of the Federal Reserve Board and other regulating agencies what action this committee takes and what this House adopts today with respect to the overall spectrum of banking regulation.

The Data Processing Industry; Bank Activity

It has been only about 25 years since work was started on the development of the first electronic digital computer. In a recent appearance before the Federal Communications Commission, the Department of Justice estimated that as of the early part of 1968 an estimated 60,000 computers were in use with another 25,000 on order. The Department estimates shipments of computers will amount to $15 billion a year by 1975. In addition to more than 80 manufacturers of central processing units, the computer industry in 1968 included more than 4,000 companies offering a wide range of related products and services. In addition, there are around 1,000 producers of computers and related hardware as well as over 2,000 organizations in the data processing services field, doing approximately $1 billion worth of business.

The data processing industry has no geographic bounds. The ability to transmit and receive data over telephone lines means that access to a computer is theoretically limited only by accessibility of a telephone. Moreover, the development of microwaves, satellites and laser beams as methods of transmission has the potential of enhancing accessibility to a computer, although there are practical difficulties at the present time.

Government regulation is negligible in the data processing field. The one area which is becoming an increasing concern is that of data communications. Computer manufacturers and common carriers have had lengthy discussions concerning the jurisdiction of the Federal Communications Commission over data communications.

Significantly, one of the few regulated areas in the computer business is that which involves commercial banks. Whether computer services are made available directly by a commercial bank or through a subsidiary or through a holding company, they come within the jurisdiction of one of the Federal or state banking agencies. Because of the wide use of computers by banks, examiners have had special instructions and training in examining a bank's computer system.

The data processing services industry, to which H.R. 6778 primaril relates, is not well-defined. In general terms it can be described as including: (1) software, application programming and consulting services, (2) computing equipment time rental, (3) data-bank services. (4) time-sharing services, (5) automated service bureaus (offering general business bookkeeping and scientific computer services), and (6) banks.

Only fragmentary information is available on the number of firms and the volume of business done in the various categories noted above. A very rough approximation of the dollar volume of business would be between $1 billion and $1.5 billion. Bank involvement involves competition with service bureaus and data centers (both independently owned and subsidiaries of manufacturers and others), companies offering time-sharing services, as well as those offering rental of computer equipment time. Banks also compete with computer software, application programming and automated service consulting firms, and, of course, with other banks offering data processing services. It is roughly estimated that banking's share of the data processing service of industry was approximately $100 million for the year 1968, or about 7 percent.

Bank participation in the data processing field was threshold and innovative. It was the banking industry that first recognized the need for improvements in record keeping in order to provide deposit and related services, priced at a level that would make these services available to all who had a valid need. Early in the 1950's the banking industry made major commitments to research programs undertaken to solve the problem of rapidly rising labor costs resulting from a dramatic increase in transaction volume.

The development of MICR (magnetic ink character recognition) by the banking industry was an outstanding example of industry wide cooperation among competing firms that led to a sound and practical solution to a difficult problem. Even though the estimated annual check volume in the United States has increased from about 7 billion in 1950 to nearly 13 billion in 1960 to a current level of about 20 billion, there has been no breakdown in the performance of the check payments system, because the industry foresaw and made the required commitments to prevent such an occurrence.

Commercial data processing, an industry which barely existed 15 years ago, owes an important part of its growth to the expanded use of electronic equipment for the handling of financial transactions--a use pioneered by the banking industry, and banking continues to be active and innovative in the data industry. For example, in 1962 the banking industry organized an ambitious standardization program for security procedures. Another area in which banking has taken a leadership position is in pioneering an industry wide standards program for improved personal identification.

The position of banking in the data processing services industry is shown by the variety of automated customer services offered by an estimated 3,800 banks. Payroll services were first offered in 1959, and as of 1969 a survey by The American Bankers Association showed that of all banks offering computer services or planning to do so within the next six months, 91.6 percent offered or intended to offer payroll services. Account reconciliation services were first offered in 1954 and provide registers showing the status of customers' checks issued, paid and outstanding; 66.8 percent of banks providing computer services now offer account reconciliation. Correspondent bank services utilize computers to provide automated record keeping services for other banks. Forty-one percent of the banks with computer services provide automated service for correspondents, a service which began in the late 1950's.

Specialized services are offered for retailers, wholesalers, physicians and dentists, and public utilities in the preparation of periodic billings, maintenance of individual customer account balances, and preparation of trial balances. Automated accounts receivable services have been sold by banks since 1959, and are offered by about one-third of the banks offering computer services. Other automated customer services provided by banks include: sales analysis, inventory analysis, freight plan, municipal tax billing, credit union services, and mortgage loan and share savings services for savings and loan associations and other lending institutions. Most of these services have been provided since the late 1950's or early 1960's.

Effect of H.R. 6778 on Banking

The limitations on the offering of data processing services by banks and by bank holding companies in H.R. 6778 could be extremely serious to the banking industry. In this connection, not only is the provision relating to data processing services of significance, but also that which would prohibit the offering by banks of "auditing or other professional services in the field of accounting." The two--i.e., data processing and so-called "accounting" services--obviously are closely linked.

In view of the wide range of services which have long been offered by banking to customers, many of which were pioneered by the banking industry, it is almost inevitable that the language of H.R. 6778 will give rise to extensive and protracted litigation. This will be instituted, of course, by competitors who will view the provisions of the House-passed bill as an opportunity to insulate themselves from competition. There are no easy answers to such question as what would constitute "economical use" of equipment; or what is included in the so-called "accounting" services, or what limits are contemplated by the language "equipment primarily acquired and used for the bank holding company or its bank subsidiaries." Thus perhaps the single greatest danger which H.R. 6778 holds out to banks is the prospect that the industry's hands will henceforth be tied in a competitive area where, ironically, it has thus far been a major, innovative force.

Even without litigation, the vagueness of the language and the possibility of restrictive interpretations of the provisions of H.R. 6778 have the potential of forcing banks out of the data processing services business. The arbitrary customers often want all of their computer services done at one location. Thus, to allow banks to provide payroll services but nothing else, would in effect mean that those utilizing the computer services of banks would simply take their business elsewhere. Not only would it be more expensive and more cumbersome to have services for various functions performed at different locations and by different computer servicing companies, but also most customers do not want their business records scattered at various locations. One of the important elements of the computer business is the integrity of the data processor in protecting the confidentiality of the data furnished to it by the customer. Obviously, banks are highly regarded in this context.

Other implications of H.R. 6778 should be mentioned. Banks often rely upon their automated customer services to make it possible for them to acquire equipment which can be much more efficient for banking purposes. If banks are henceforth to be limited to the acquisition of equipment primarily intended for use of the bank, the prospect of continued improvements and efficiency will be thwarted.

The ability of many small or medium-sized banks to remain competitive with so-called "downtown" banks is dependent upon their offering data processing services to customers. H.R. 6778 would, in this circumstance, have a distinct anti-competitive effect by depriving these banks of an important competitive tool.

In the final analysis, by placing limits on bank participation in the offering of data processing services, H.R. 6778 strikes at the very heart of the modern-day industry. The consequences for banking could well be devastating.

Public Policy Issues

There are two public policy issues of major importance which relate to the data processing provisions of H.R. 6778--technological progress and competition. Both are of significance to consumers, whether individual or business. Of lesser significance is the matter of possible risk to banks.

Technological progress. From discussion earlier in this paper it should be quite evident that the banking industry has played a key role in the development and implementation of data processing services and of the equipment needed to provide them. H.R. 6778 would sharply curtail banking's role in the future. Such a step could only have adverse consequences for the consuming public.

Competition. As is the case with other provisions of H.R. 6778 limiting bank services, banking's competitors claim that by reducing or eliminating the ability of banks to offer data processing services the threat of "excessive concentration of economic power" is avoided. In particular such a claim was advanced during House hearings by a spokesman for the Association of Data Processing Service Organizations. The issue, of course,is one which requires consideration.

The structure of the data processing service industry provides perhaps the best answer to the charge of concentrated economic power. According to testimony by the ADPSO witness there are approximately 1,600 non-bank firms in the industry, two-thirds of which gross less than $300,000 annually. A.B.A. survey data show that in 1969, there were about 3,800 banks offering automated customer services, of which 3,400 had deposits of less than $100 million. It is difficult--indeed impossible--to see how the exclusion of these banks--the large majority of medium or small size--would contribute to the public's freedom of choice among the best services at the best prices.

Also significant is the fact that even though banking pioneered in the offering of data processing services, it has today only about 7 percent of the total industry business. If banking in fact could capitalize on its hypothetical "power" one would scarcely expect it to occupy such a modest position in the industry.

It seems evident that the real issue here is simply the desire of non-bank firms to reduce the present level of competition by insulating themselves from bank competition. Such attempts are purely self-serving and never in the public interest.

Risk. Mention should be made of allegations, again by ADPSO, that there is undue risk to banking in the offering of data processing services.

Exposure to liability arising from error is part of the day-to-day life of the banking business. If banks are to use modern technology in processing checks, loans, and other activities--which most people agree is a necessary and desirable activity--how can it be said that logical extensions of this type of data processing materially increase the potential liability? Indeed, if potential liability is a regular problem, and the customer's interest is paramount, is not the banking industry far better equipped to provide such services because it regularly faces such liability and has set up internal auditing and system standards appropriate for such liability and because it is a highly regulated and monitored industry, and because the services being offered are backed up by a more comprehensive programming, analytical, and customer relations support group?

Whether bank shareholders are sufficiently aware of the risk being undertaken by banks by virtue of their offering data processing service: can only be appropriately evaluated by an examination of shareholder reports and other shareholder communications. The central point is tha shareholders should be told that which is important in evaluating the firm and the major activities should obviously have more coverage than minor ones. The facts are that data processing services constitute a relatively minor portion of the total activity of most banks. A review of recent annual reports suggests that these activities are being adequately covered when viewed in the context of their importance to the financial health of the reporting bank.

MONETARY CONFERENCE

THE AMERICAN BANKERS ASSOCIATION 815 CONNECTICUT AVENUE, N. W., WASHINGTON, D. C. 20006

February 10, 1970

To All Participants in the A.B.A.'s Seventeenth Annual Monetary Conference, Hot Springs, Virginia, May 17-20, 1970

Mr. William Moore, Chairman of the 1970 Monetary Conference has asked me to thank you for your acceptance of his letter of invitation and to tell you how pleased we are that you will be attending.

Plans for the program are almost complete and as soon as all of the speakers have been finalized a preliminary copy of the program, including the list of attendees, will be sent to you. In the meantime, we thought you might like to have the enclosed outline of the program.

Some additional information on the procedures for the Conference is listed below. Also enclosed is a questionnaire pertaining to some of these details, which we would appreciate your completing and returning to me at your earliest convenience. An extra copy is enclosed for your file.

(1) For those of you who may be arriving in Washington on or before Saturday, May 16, or would like a reservation in Washington following the Conference, a block of rooms has been set aside at the Madison Hotel and we will be glad to make a reservation for you.

(2) A luncheon has been scheduled at the Madison Hotel for Sunday, May 17, beginning at 12:00 o'clock.

(3) Bus transportation has been arranged from Washington to The Homestead. The buses will leave from the Madison Hotel at 1:00 p.m.

For the return trip, the buses will leave The Homestead at 3:00 p.m. and should arrive in Washington approximately 8:00 p.m.

(4) Unless your letter of acceptance indicated otherwise, a room reservation at The Homestead has been made for you from late afternoon on Sunday, May 17, through 3:00 p.m. on May 20. You should have already received a confirmation of this reservation directly from The Homestead. If you plan to arrive before the 17th or leave after the 20th and have not already notified us of this, please let me know as soon as possible since facilities at The Homestead must be booked well in advance.

We look forward to your participation in the Seventeenth Monetary Conference. Please do not hesitate in letting us know of any assistance we may be able to provide.

Sincerely,

Roy W. Terwilliger
Deputy Manager

<u>Please address reply or inquiry to</u>:
Mr. Roy W. Terwilliger
The American Bankers Association
815 Connecticut Avenue, N.W.
Washington, D.C. 20006

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

WILLIS W. ALEXANDER
EXECUTIVE VICE PRESIDENT

February 27, 1970

Dear Dr. Burns:

On Saturday night, April 18, a cocktail and dinner party will be held during our Spring Meeting, honoring President and Mrs. Nat S. Rogers, to which are being invited members of the Administrative Committee, chairmen of A.B.A. committees, former presidents, former treasurers, official guests, and senior staff officers. I hope very much that you will be able to attend. Wives, of course, are invited.

Cocktails will be served in Chesapeake Hall, on the main floor of The Greenbrier, starting at 7 p.m., and dinner at 8 p.m., also in Chesapeake Hall. Black tie is customary at this annual function.

Please let me know if you will attend.

Sincerely yours,

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

(212) 972-5100

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American
Bankers
Assoc.

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

NAT S. ROGERS
PRESIDENT

FIRST CITY NATIONAL BANK
HOUSTON, TEXAS 77001

March 5, 1970

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

Dear Dr. Burns:

In response to the recent conversation between you and Willis Alexander, Executive Vice President of The American Bankers Association, we have prepared a memorandum of proposals which we believe will increase the flow of funds into housing. A recently appointed bankers' task force on housing is continuing to work diligently on this problem and will be able to advance further ideas as time goes on.

We would be glad to discuss any of these proposals with you at any time or to furnish additional information if you desire.

Sincerely,

Nat S Rogers

Nat S. Rogers

Enclosure

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

NAT S. ROGERS
PRESIDENT

FIRST CITY NATIONAL BANK
HOUSTON, TEXAS 77001

March 5, 1970

MEMORANDUM

TO: Arthur F. Burns, Chairman
Board of Governors of the Federal Reserve System

FROM: The American Bankers Association

SUBJECT: Proposals to increase the flow of funds into housing

The flow of funds into home mortgages has been inadequate to meet the stated goals in the Housing Acts of 1968 and 1969. We believe private enterprise and financing, properly motivated, can do the job. The importance and seriousness of the housing problem might well require extraordinary measures. To better enable mortgage lenders to meet home financing requirements, The American Bankers Association recommends that the following incentive proposals be adopted by the Federal Government:

(1) Permit a deduction for tax purposes of a portion of the interest earnings on low- and moderately priced housing.

(2) Permit member banks to discount mortgages at the regular, non-penalty discount rate.

(3) Eliminate or reduce reserve requirements of member banks against savings invested in residential mortgages.

(4) Amend section 24 of the Federal Reserve Act to allow national banks to invest the greater of 100 percent of time and savings deposits (now 70 percent of time and savings deposits) or 100 percent of capital and surplus in real estate mortgages.

(5) Amend section 24 of the Federal Reserve Act to permit national banks to make 90 percent mortgages for terms up to 30 years, provided further that the instalment payment provision for all real estate loans be adequate to liquidate the loan within the maximum permissable legal term and not by the date of maturity.

(6) Create a secondary market for conventional mortgages in the Federal National Mortgage Association.

All of these would stimulate the flow of bank funds into housing, but two of the proposals, (1) and (6), would also apply to other lenders.

Proposals (4)-(6) are either self-explanatory or have been the subject of considerable discussion in the past. The following provides additional details on proposals (1), (2) and (3).

Exemption From Income Tax of A Portion of The Interest Income on Residential Mortgages

In keeping with the recent Adminstration proposals on the Tax Reform Bill, a certain portion of interest earned on residential mortgages might be made deductible from the tax base. Eligibility for deductions could be limited to mortgages on homes valued at less than $25,000 -- and a comparable amount per unit of multi-family housing -- to stimulate construction for middle- and lower-income families. However, the Administration's proposed 5 percent deduction would not be nearly enough to reduce mortgage rates on middle- and lower-income housing to reasonable levels on a competitive basis with the after-tax return on alternative investments. By way of illustration, a 6-1/2 percent mortgage rate with an allowable deduction of 25 percent for tax purposes would be equivalent to a non-deductible 8-1/8 percent return at a 50 percent marginal rate of tax.

Competition would quickly and effectively reduce the rates on mortgages eligible for deduction. In so doing, private enterprise would have a suitable incentive to demonstrate its ingenuity and capability.

Such a tax incentive is a much more efficient method of increasing funds available for housing than direct lending by the Government. It can be shown that at recent costs of Government financing direct lending would provide only about a third of the housing volume that could be supported by a 25 percent tax incentive, involving the same amount of tax dollars. The attached appendix shows the details of this analysis.

Moreover, under the tax incentive method, the rate charged homeowners would have built-in flexibility to move downward if prevailing rates on nondeductible mortgages decline, while a subsidized rate on direct Government lending would remain fixed until changed by legislation or by administrative determination.

Permit Member Banks to Discount
Mortgages at the Non-Penalty Rate

Any housing mortgage of good quality should be eligible for discount at the Federal Reserve window without requiring a penalty discount rate. We recommend that recognition be given to the special purpose and nature of making mortgages eligible for rediscounting. Although we do not recommend a specific term, little would be gained for improving the availability of home financing if the usual period of borrowing at the discount window is strictly enforced.

The availability of the discount window together with appreciably longer terms of borrowing would add a significant degree of liquidity to mortgages which they do not now have, and would thus encourage mortgage holdings by bank lenders. We recommend further that interim financing of construction also be included in the list of eligible paper.

Reduced Reserve Requirements Against Savings Invested in Residential Mortgages

Motivation might also take the form of reducing reserve requirements of member banks against savings invested in residential mortgages. This could easily unfreeze a substantial sum for home mortgage use. For example, a reduction in reserve requirements against time deposits equal to 1 percent of the nearly $35 billion in residential mortgages held by member banks in December, 1969 would free $350 million for further lending, plus the additional amounts arising out of the multiplier effects of the fractional reserve system. We recognize that a proposal such as this, particular the extent to which the multiplier effects will be permitted, must be consistent with overall monetary policy objectives.

The addition of such housing related credit as construction loans and loans on mobile homes to the base eligible for reserve requirement reductions would add measurably to the amount available for new home financing. Moreover, many State statutes tie the reserve requirements for non-member banks to those of the Federal Reserve.

APPENDIX

Analysis of Net Cost to Government of Direct Lending and the Amount of Privately Financed Housing Such Cost Would Support

(Assuming 25% of Interest Earned is Deducted from Tax Base)

There is a proposal before the Congress, H.R. 13694, which calls for Federal Government appropriations of $2.0 billion a year for 5 years (a total of $10 billion), to finance mortgages on housing for medium-income families. The money would be used to finance 6½ percent mortgages of $24,000 or less, on homes bought by families with annual incomes not greater than $12,000. After 5 years, the $10 billion appropriated would become a revolving fund for continued lending out of interest and principal repayments.

As an alternative it is suggested that private lenders be allowed a deduction for tax purposes of 25 percent from interest earnings on similar qualifying housing. The question is how much privately financed housing could be supported by the cost of the direct subsidy program under H.R. 13694, if instead the same cost is absorbed by the Government in diminished tax collections.

The $10 billion loaned by the Government would be a capital investment representing the acquisition of the mortgages as assets. Although treated as a lending expenditure under the budget concept, its real nature is a purchase of assets. It is true that a lending expenditure of the Government requires tax dollars or borrowing. But to compare that expenditure with an annual tax cost, it is necessary to translate it into a series of yearly payments.

In that translation the big cost is, of course, the interest rate on Government borrowings. In addition there are loss expenses as a result of defaults and the cost of administering the program. Offsetting these costs is the 6½ percent return on the mortgages under H.R. 13694. The net cost -- depending on the Government's borrowing cost -- is shown on the following table:

Cost to Government of Maintaining $10 Billion in Home Mortgages at 6½%

	Average Government Borrowing Rate	
	7%	8%
	(million of dollars)	
Annual gross cost of:		
Gov't borrowing	$700	$800
Administration (3/8% assumed)	38	38
Losses (½% assumed)	50	50
Total	$788	$888
Annual income on 6½% loans	650	650
Annual net cost	$138	$238

Instead of these net costs each year, the same amounts in tax losses could be incurred to support the private financing of eligible mortgages by allowing a 25 percent deduction from the tax base. At a 50 percent marginal rate of tax and a 6½ percent rates of return on these mortgages the totals that could be supported are shown below:

Amount of Privately Financed Mortgages Supported by Tax Incentives Equal to the Net Cost of Public Financing 1/

	Average Government Borrowing Rate	
	7%	8%
	(millions of dollars)	
Total privately financed mortgages	$16,922	$29,223
Gross annual income at 6½%	1,100	1,900
25% deduction from income	275	475
Tax loss on deduction (50% tax rate)	138	238
Total housing supported, assuming loan to price ratio of 90%	18,800	32,470

1/ Assuming 25% allowable deduction for tax purposes from 6½ percent interest on mortgages outstanding.

A further advantage of encouraging private financing through tax incentives is that if prevailing rates on nonqualifying mortgages decline, the rates charged on qualifying mortgages would have flexibility to decline also. This would mean more mortgages that could be supported by the same amount of net cost to the Government. For example, instead of $16.9 billion of mortgages based on $138 million in tax loss at a 6½ percent mortgage rate, the amount of mortgages at 6 percent would be $18.3 billion, equivalent to $20.4 billion of housing at a loan to price ratio of 90 percent.

~~CHAIRMAN~~ BURNS

For Information Only

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

Office Correspondence

Date April 6, 1970.

To Board of Governors

From Office of the Secretary

Subject: ABA research paper

Attached is a copy of a paper prepared by the ABA's Department of Economic Research concerning the Monetary Policy Implications of Increasing the Involvement of Non-Bank Intermediaries in the Payments System. This may be of interest in view of the several Board discussions of the subject during the past few months. Copies of the paper were received recently by Governor Mitchell's office.

Monetary Policy Implications of
Increasing the Involvement of
Non-Bank Intermediaries
In the Payments System

Department of Economic Research
American Bankers Association
February 1970

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Introduction

In at least four jurisdictions legislators and banking supervisory authorities are being asked to approve a radical proposal in American financing -- that of allowing financial intermediaries other than commercial banks to extend their functions to include those of making payments transactions, an area traditionally reserved to commercial banks. In three states mutual savings banks are attempting to obtain powers to extend checking account services to customers. In addition, a proposal has been made to allow Federal savings and loan associations to provide bill-paying services for customers.

The issue this paper addresses itself to involves the implications for monetary policy of such moves. Three aspects are apparent in the problem of how monetary policy would be affected if financial intermediaries had the power to furnish payment transactions services to their customers.

Impact of the introduction of checking accounts or easy transfer of payments at many new intermediaries.

Responsiveness to monetary control of that part of the money supply furnished by non-bank intermediaries.

Effectiveness of measures such as reserve requirements in establishing monetary control over intermediaries.

Because there has been almost no experience with the problem in the United States and foreign experience is not directly relevant, a large part of the argument must be based on logical analysis. Nevertheless, there are a number of facts at crucial points in the analysis which have bearing.

Summary of Study

Proposed additions of powers to permit immediate payments by or on behalf of depositors of mutual savings banks and savings and loan associations raise questions of whether the degree of monetary control exercised by the Federal Reserve System may be weakened if the measures are adopted. In the case of mutual savings banks, a new form of demand deposits outside the commercial banking sector would be created by the proposals, in effect producing an additional number of non-member banks. In the case of savings and loan associations, the addition of a bill paying service through "non-negotiable transfers" could result in an increase in the turnover of funds held in savings shares. In both cases the distinction between demand and time or savings deposits would be blurred if the new powers are granted.

This study first examines the likely impact of the initial introduction of the proposed powers and concludes that the immediate reaction may be an increase in the money supply or an increase in its velocity of unknown degree which can only imperfectly be offset by the usual measures available to the central bank. The measures available to monetary authorities will work more severely on commercial banks than on the intermediaries causing the problem. The problem is not confined to control of monetary variables at the introduction of the proposed powers but more importantly concerns the continuing control any central bank requires over money and credit creation. The study goes on to review the current place of intermediaries in monetary thought, noting that even with only their present powers, a major school of thought believes that non-bank intermediaries are not neutral in a monetary sense. After citing a number of investigations of the similarity of behavior of intermediary claims and conventional definitions of the money supply, the study proceeds to test, using recent data, whether the correlation of money and economic activity is improved as deposits of mutual savings banks and savings and loan shares are included in the definition of money. This is found to be the case. Further confirmation of the likelyhood of a problem to monetary control arising as a result of the proposed additions of powers to intermediaries is indicated by reference to the recent accelerated growth of deposits at non-member banks, since the effect of the proposals would be to create, in effect, an addition to this class of financial institution.

The study then examines the allied problem of monetary control over non-bank intermediaries through reserve requirements. While existing liquidity requirements on intermediaries are sometimes equated with conventional bank reserve requirements, it is pointed out they do not perform a monetary control function. Under the proposals the first steps would be taken to provide intermediaries with multiple credit expansion ability, a power not previously held by them. This directly affects monetary control which depends on a direct link between the volume of bank reserves and the volume of claims serving as means of payment.

The traditional argument that Federal Reserve control is sufficient even if directly exercised only on a limited base of Federal Reserve member banks is refuted by reference to the recent behavior of non-member banks, by expressed Federal Reserve concern over the problem and by logic. The study concludes that monetary control would be made increasingly difficult if non-bank financial intermediaries are permitted to provide a means of payment as is the intent of the proposals.

<u>Nature of the Proposals</u>

The Housing and Urban Development Act of 1968 amended the Home Owners

Loan Act of 1933 to provide that Federal savings and loan associations may "provide for withdrawal or transfer of savings accounts upon non-transferable order or authorization". Approximately a year later, August 13, 1969, the Federal Home Loan Bank Board published proposed amendments to regulations to authorize such instruments. Both the Housing Act and the HLBB provisions contain wording to the effect that savings accounts "shall not be subject to check or to withdrawal or transfer on negotiable or transferable order or authorization to the association". The enabling regulation as shown in the Federal Register contains the following principal specifications:

> Payments may be made on non-transferable order periodically or otherwise.
>
> Orders for payments for periodic obligations may be honored without specification as to the amount upon specification of the nature of the obligation.
>
> Order for such payment may be treated as a withdrawal request or a transfer to a third party's savings account.

The language of the HLBB amendment specifically mentions utility bills as a type of obligation that could be handled by non-negotiable transfer but it does not exclude payments that could be authorized irregularly and at will by the savings account holder. Thus, at least potentially, the effect of the HLBB proposal, if followed by state chartering authorities, would be to convert an unknown part of the $130 billion in savings held at savings and loan associations into a form close to commercial bank demand deposits.[1/]

1/ A bill (H.R.29) permitting Federal savings and loan associations to accept demand deposits was introduced early in 1969 by Representative Wright Patman. This bill provided for 100 percent reserves against such deposits to be held by the association with the Federal Reserve Bank.

During 1969 a bill to authorize savings banks in the State of Connecticut to extend checking account services to depositors was defeated but the question is to be reconsidered after receipt of recommendations of a study commission to be made on or before December 1970. A similar proposal has been brought before the New York Legislature at various times. One savings bank in Delaware has requested a change in its charter to permit such a move. The Connecticut bill indicated that demand deposits held by mutual savings banks would be subject to the same reserve requirements as non-member banks. Together, Connecticut and New York account for almost $40 billion of the $55 billion mutual savings bank deposits.

Citing the desirability of diversification of powers to increase customer convenience, an inter-industry study group of savings and loan associations and mutual savings banks recently released a study wherein it was suggested that the public interest did not require monopolization of checking accounts by the commercial banking industry.[1/] While the author questioned whether the thrift industry should not take the leap directly into automated payments system without becoming involved in checks, he concluded that the uncertainties were such that it would be better to press for limited checking account privileges. It may be significant that in a list of 13 specific measures that mutual savings banks and savings and loan associations could take to improve their position according to the author,

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1/ Leo Grebler, The Future of Thrift Institutions, A Study of Diversification Versus Specialization, Joint Savings and Loan and Mutual Savings Bank Exchange Groups, Danville, Illinois; 1969.

obtaining authority to extend checking account privileges to customers was ranked as number three, being exceeded in immediate importance by authority for consumer lending and steps to increase longer-term and fixed maturity liability instruments. In an industry beset with problems the recommendation of this self-study investigation by a prominent author should not be brushed off.

Of perhaps greater potential threat is the recommendation for limited checking account privileges by the savings and loan associations made by Professor Irwin Friend in the summary and recommendations volume of the major study prepared for the Federal Home Loan Bank Board at the request of the Administration and the Congress. Since the study comes fairly close to the formal status of a White House or Congressional commission its recommendations probably have more than average weight. Unfortunately, up to this time only the summary and recommendations are available and analysis of the case for checking accounts awaits publication of the supporting studies.

For purposes of this study we regard as similar cases both the proposals to allow mutual savings banks to extend checking account privileges to customers and the proposal to allow Federal savings and loan associations to provide bill paying services for customers. Both are excursions by non-bank institutions into the payments system, heretofore a field essentially confined to commercial banks. The effect of both can be regarded as (1) increasing the volume of demand deposits, (2) altering the division between demand deposits and savings or (3) increasing the velocity of savings. All the proposals therefore raise questions of the effectiveness of monetary control and can be regarded as the same for purposes of this paper.

Enough has been said above to point out that the present commercial banking industry monopoly in providing means of payment is under serious attack. The expressed rationale for extending such privileges to non-bank intermediaries so far as we know rests on only one point, that the long-term growth of such institutions depends on being able to offer a wider range of services than now available since even the present differential interest rate on passbook savings accounts in favor of the non-banks is said to be insufficient, as compared to customer convenience, as a force to attract funds.

Significance

As Table I indicates, the volume of mutual savings bank deposits and savings and loan shares in the U.S. is approximately equal to the volume

Table I

Comparisons of Deposits (and savings capital) of Financial Institutions
December 31, 1968

	Millions
Commercial Banks	
Demand	204,207
Time	193,068
Mutual Savings Banks	68,871
Savings and Loan Associations	129,722

Source: Annual Report of the F.D.I.C., Combined Financial Statement, FHLBB

of demand deposits at commercial banks. While no one contends that the full amount would be "monetized" by conversion to demand deposits, the effect of even the limited privilege would be to increase the ease with which these assets can become "money" and therefore would be of importance for monetary control as will be seen.

An additional comparison is perhaps necessary to put the specific proposals in perspective. As will be noticed in Table II, mutual savings banks already show minor amounts of demand deposits although the largest part of this is in escrow accounts and little is in true checking accounts. Only New Jersey, Delaware and Indiana allow mutual savings banks to freely offer checking accounts although a few other states including Connecticut allow limited checking account services under old charters.

Table II

Deposits (and savings capital) of Financial Institutions in Selected States - December 31, 1968

(Millions of Dollars)

	Connecticut	New York
Commercial Banks (Insured)		
Demand	2,748	51,640
Time	2,057	30,408
Mutual Savings Banks (Insured)		
Demand	37	299
Time	4,483	38,009
Savings and Loan Associations (Insured)	1,149	8,412

Source: F.D.I.C. and Home Loan Bank Board

In both Connecticut and New York the present liabilities of mutual savings banks are very large relative to commercial bank deposit liabilities and, in fact, in Connecticut, savings banks and savings and loan associations have a greater volume of deposits than commercial banks. The present scheme of separating non-bank intermediaries from commercial banks at least requires a separate physical act to convert savings into demand deposits. This impediment is reduced or eliminated by the proposals under examination. Without indicating the precise degree to which the $197 billion savings and loan and mutual savings bank deposits become fully comparable with commercial bank demand deposits, it is worthwhile to consider the effect of such a move on the control of the economy exhibited by the Federal Reserve System.

Impact of Introduction

In the period of introduction, mutual savings banks and savings and loan associations obviously hope to attract accounts from commercial banks but must face the possibility that some of their present savings deposits may be converted to checking account form either by deliberate segregation (as in the savings bank scheme) or by direct usage (in the case of the non-negotiable transfers of the savings and loan associations). In the long run, of course, the intermediaries hope to gain full household acceptance as banks as a result of being able to offer the advantages of "one-stop banking".

There is no way of knowing beforehand how much the liberalization of non-bank intermediary deposit and payments powers might act to increase the money supply. Indeed, it might merely increase the velocity of savings deposits as savers made frequent transfers in and out their interest bearing accounts in order to maximize earnings on their total balances. The states now permitting demand deposits at mutuals, Indiana, New Jersey and Delaware, show only about two percent of total mutual savings bank deposits are in demand form. On the other hand, the Connecticut mutuals are likely to be considerably more aggressive than the mutuals in these states as they bulk larger in the financial structure and already have strong marketing orientation towards enlargement of total banking services. It seems reasonable to believe therefore, that an addition to aggregate demand deposits will occur, not merely a reduction in commercial bank demand deposits as, and if, mutuals expand into this area.

How would the Federal Reserve offset such a jump in the money supply or increase in the velocity of savings? While a quantum jump in bank reserves as a result of a legal redefinition (such as that in 1959 when cash in vault was made part of reserves) can be simply offset by either increases in reserve requirements or sales of securities through open market operations, the same tactics do not necessarily operate in the case of an increase in the money supply. Presumably the monetary authority attempting to offset savings balances that became activated at intermediaries would only have instruments to reduce demand balances at commercial banks or increase their reserve requirements. This would involve open market sales with consequent effect on rates on money market instruments in the commercial bank investment area but only delayed effects on investment areas served by savings and loan associations or mutual savings banks.

Monetary Powers of Intermediaries

The question of how the Federal Reserve System's present control over the economy might be altered as a result of new powers granted to non-bank intermediaries requires some explanation of the current thinking on the role of intermediaries in the financial system. Are they, under their present powers, neutral in a monetary sense or do they have an impact on the real economy similar to banks? If mutual savings banks and savings and loan associations are presently neutral and are given additional powers which would make them non-neutral, a danger exists that the central bank's effectiveness would be reduced. If intermediaries are not presently neutral the granting of further powers might increase the problem the Federal Reserve faces in controlling the economy. At any rate, a discussion of present thought on the subject appears essential.

In traditional monetary theory commercial banks are unique in that their lending and investing activities are carried out by issuing their own liabilities (deposits) which are accepted as means of payment. Thus, a check on the First National Bank representing the proceeds of a loan by that institution will, in the normal procedure, be honored as payment. While the individual bank is unable to expand credit and therefore the amount of money beyond the deposits which it can attract (since it must pay out its reserves to make good its liabilities), the banking system can, if supplied sufficient reserves, expand the total of its liabilities and therefore the total supply of money.

It is otherwise for intermediaries since they do not create their own liabilities which are honored as means of payment. Savings and loan shares or mutual savings bank passbooks are not good for payment and are not used to satisfy obligations. Instead, these institutions stand ready to redeem their obligations and pay out cash or checks drawn against their own accounts in commercial banks if a depositor wishes to withdraw funds. Thus, the credit-extending powers of intermediaries through their lending and investing activities do not result in the creation of new liabilities which are accepted as means of payment. The necessity to make any and all transactions with depositors or borrowers through payment of cash or demand deposits at commercial banks limits both the individual institution and intermediaries as a group to strictly non-credit creating functions. Guttentag and Lindsay perhaps have stated it most succinctly.

> Banks are indeed uniquely important because, much more than other intermediaries, they are potentially a source of cyclical instability....what (does) all this (have) to do with the fact that only banks create money (?). The greater credit expansion of banks, it will be recalled, occurs because banks do not suffer significant leakages of reserves, when they extend credit. This in turn stems from the willingness of non-bank intermediaries to hold their reserves in the form of claims against banks. And this they do because banks create money.1/

Orthodox theory, in denying that financial institutions without checking account privileges have the power to create credit, absolves them essentially from any need to be responsive to monetary control. By expanding or contracting the money supply and therefore income and savings through control over the amount of commercial bank reserves, eventually the lending and investing powers of intermediaries may be affected because their rate of growth of deposits will change. This is the only control method recognized by orthodox theory and is deemed by holders of this view to be fully sufficient with present powers of intermediaries.

1/ Jack M. Guttentag and Robert Lindsay, "The Uniqueness of Commercial Banks", The Journal of Political Economy, January 1969, pp. 1012-3.

The orthodox view of the monetary powers of intermediaries has been challenged at numerous points in recent years. Gurley and Shaw have suggested that intermediaries grant credit in the form of loans or investments which obviously affect the economy by expanding consumption or investment. They point to the growth of intermediaries relative to commercial banks and suggest that the intermediary process results in acceleration in the velocity of money.1/ Thus, those who follow Gurley and Shaw are concerned that even with no additional powers, intermediaries have the ability to affect the economy independently of monetary control. James Tobin of Yale University has carried this thesis one step further and argues that commercial banks are merely one more intermediary and that no unique function should be attributed to them because of their power to issue demand liabilities that are acceptable as means of payment.2/

The battle over whether or not the claims of non-bank intermediaries are money as claimed by Gurley and Shaw has tended to revolve around various econometric tests to find if they are complements or substitutes to money. If the public reduces their demand deposits when they increase mutual savings bank deposits or savings and loan shares, it is reasoned that the latter

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1/ J. G. Gurley and E. S. Shaw, "Financial Aspects of Economic Development", American Economic Review, September 1955 XLV 515-38 and "Financial Intermediaries and the Saving-Investment Process", Journal of Finance, May 1956, XI 257-76. The classic refutation of the Gurley-Shaw thesis is given by J. M. Culbertson in "Intermediaries and Monetary Theory: A Criticism of the Gurley-Shaw Theory", in American Economic Review, March 1958, XLV III 119-131.

2/ "Commercial banks do not possess, either individually or collectively, a widow's cruse which guarantees that any expansion of assets will generate a corresponding expansion of deposit liabilities." See James M. Tobin, "Commercial Banks and Creators of Money", in Deane Carson ed., Banking and Monetary Studies, Irwin, 1963, p. 418.

assets are substitutes for the former, while if they increase them or at least leave demand deposits undisturbed they are complements. The implication is, of course, that money substitutes are not neutral and may be a cause of economic instability unless controlled whereas complements need not be subject to control.

Unfortunately, the various tests are not conclusive despite the claims of their authors. Brunner and Meltzer 1/ and Hamburger 2/ have concluded currency and demand deposits are the best definition of the money supply. On the other hand, T. H. Lee 3/ and V. K. Chetty 4/ have concluded the opposite. The latter author, the most recent to examine the evidence, has concluded that time deposits, mutual savings bank deposits and savings and loan shares are substitutes for demand deposits in that order.

In an unpublished dissertation for the University of Southern California, William Rogers Watson attempted an empirical investigation of the "moneyness" of savings and loan shares and concluded the Gurley-Shaw thesis could not be

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1/ Karl Brunner and Allan Meltzer, "Predicting Velocity: Implications for Theory and Policy", Journal of Finance, 1963.

2/ M. J. Hamburger, "The Household Demand for Financial Assets", Econometrica, January 1968.

3/ Tong Hun Lee, "Substitutability of Non-Bank Intermediary Liabilities for Money", Journal of Finance, September 1966.

4/ V. K. Chetty, "On Measuring the Nearness of Near-Moneys", American Economic Review, June 1969.

rejected. He found

> "For changes in initial stocks, the results indicate that demand deposits and time deposits at commercial banks are "weak" substitutes, whereas demand deposits and savings and loan association shares are "weak" complements. This complementary relationship might be explained by the hypothesis that savings and loan associations increase their stock demand for demand deposits in response to an increase in the initial stock of their liabilities by more than the other sectors decrease their stock demand for demand deposits for an increase in the initial stock of savings and loan association shares." 1/

Of greater current interest than either the orthodox view or the Gurley-Shaw approach is the treatment of financial intermediaries by the monetarists or Friedman school. Superficially, the approach of this group follows the orthodox school in that intermediaries are dismissed as dependent upon bank demand deposits to make any credit extended good. Friedman regards the postwar expansion of savings and loan shares as (1) merely a manifestation of the velocity increase and (2) predominately at the expense of assets other than money.2/ It is interesting to note that the ambivalent definition of the money supply of Friedman and his followers has never encompassed savings deposits of mutual savings banks or savings and loan shares although his M_2 includes savings deposits at commercial banks (later modified by some monetarists to exclude large certificates of deposit).

1/ William Rogers Watson, The Interaction Among Financial Intermediaries in the Money and Capital Markets: A Theoretical and Empirical Study, unpublished dissertation, University of Southern California; 1968, p.406.

2/ Milton Friedman and Anna Schwartz, A Monetary History of the United States, National Bureau of Economic Research, p.666-7.

The foregoing summary of current thought on the monetary powers of intermediaries indicates that many economists believe even with only their present powers these institutions provide some problem for monetary control. It is worthwile, however, to examine how much the liabilities of these institutions vary over time and whether they behave in a manner similar to money. This is the subject of the next section.

The Stability of Claims on Financial Intermediaries and their Relation to Money

Perhaps Warren Smith summarizes best thinking of a decade ago on monetary control of intermediaries:

> ....There is no evidence of systematic destabilizing shifts between demand deposits and claims against other intermediaries, such as mutual savings banks and savings and loan associations. However, if such shifts should raise difficulties in the future, their destabilizing effects can be eliminated by the application of appropriate legal reserve requirements to these institutions. This is a straightforward remedy which is entirely consistent with the traditional concepts of central banking, and we should be prepared to put it into effect if necessary. It should be noted, however, that if we impose the same effective reserve requirements on savings institutions as are applicable to demand deposits in order to eliminate destabilizing effects, we also take away the intermediary status of these institutions, since under these circumstances, a deposit of current saving in a savings institution will reduce the lending power of the banking system as much as it will increase the lending power of the savings institution.1/

Whether the lack of direct monetary control on all institutions but Federal Reserve member banks threatens the ability of monetary policy to influence the economy depends largely on whether the addition of liabilities

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1/ Warren L. Smith, "Financial Intermediaries and Monetary Controls", Quarterly Journal of Economics, November 1959.

of these institutions improves the correlation of money supply to income and production. If the correlation is improved significantly the presumption is that the claims of intermediaries have significance in the cyclical process and that monetary control would be reduced by any measure that adds to the functions of these institutions.

Four bits of evidence exist on which to determine how intermediary claims should be considered in monetary theory - (1) historical correlations, (2) recent forecasting ability, (3) anology with non-member banks and (4) recent trends of member and non-member deposits.

As part of one of the major empirical tests of the Friedman explanation of U.S. business cycles in terms of the quantity theory of money, Timberlake and Fortson tried several definitions of money including an expanded definition which included, besides the familiar demand deposits and currency, time deposits at commercial banks and at savings banks.

Table III [1]

Simple Correlations of First Differences
of (1) Money Supply plus Commercial Bank Time Deposits (M_2)
and (2) Above Plus Savings Bank Deposits (M_3) on Income

	M_2	M_3		M_2	M_3
1897-1908	.890	.820	1933-1938	.766	.865
1903-1913	.788	.813	1938-1953	.006	-.145
1908-1921	.766	.726	1934-1948	-.009	-.171
1913-1920	.786	.727	1948-1960	.408	.285
1920-1929	.700	.702	1953-1965	.609	.633
1921-1933	.801	.772	1929-1960	.501	.427
1929-1939	.882	.865	1897-1960	.573	.517

1/ Richard H. Timberlake, Jr. and James Fortson, "Time Deposits in the Definition of Money", American Economic Review, March 1967, p.192

Numerous time periods were examined for the years 1897-1965 depending on the availability of data and periods of roughly similar economic conditions. In 4 out of the 14 time periods examined, the addition of deposits at savings banks improved the correlation with income although the increase was not large. More important, however, was the fact that during the most recent period 1953-1965 the correlation showed a substantial improvement as a result of the addition of savings bank deposits to the money supply definitions.1/

What does more recent evidence show about the movement of intermediary claims and changes in the economy. For the period from the fourth quarter of 1961 through the second quarter of 1969, an analysis was made of the relation between changes in (1) M_1, (2) M_2, (3) M_2 plus mutual savings bank deposits and (4) M_2 plus mutual savings bank deposits and savings and loan shares. The latter two variables when added to the previous ones are known and M_3 and M_4 for brevity. The results of the stepwise regressions (in order of importance of the independent variage) are shown in Table IV for both six and nine month lags of the dependent variable.

Table IV

Coefficients of Determination for Quarterly Changes in M_1, M_2, M_3 and M_4 Regressed on Quarterly Changes in Gross National Product Lagged 6 and 9 Months

Six Month Lag		Nine Month Lag	
M_1	.4905	M_3	.4250
M_2	did not pass F level test of 2.0	M_1	.4799
M_3		M_4	.5348
M_4		M_2	did not pass F level test of 2.0

1/ ibid., pp.190-193

This test is a relatively severe one because it involves both short-term changes and a dependent variable subject to relatively wide fluctuations. Nevertheless, it suggests that both mutual savings bank deposits and savings and loan shares even under present definitions have properties similar to money and therefore can be considered part of the means of payment.

There exists a class of financial institutions that are not directly subject to monetary control but whose liabilities circulate as means of payment. These are commercial banks that are not members of the Federal Reserve System. For most of these banks reserve requirements are less stringent than those imposed on member banks and more types of assets, including some types of earning assets, are eligible for inclusion. This importantly includes correspondent bank balances. Hence neither changes in reserve requirements, borrowing nor open market purchases necessarily affect non-member banks. The behavior of non-member banks relative to member banks has some bearing on the degree of monetary control that may or may not be involved in commissioning a new group of "non-member" banks.

In an analysis performed for the Commission on Money and Credit, Clark Warburton found that non-member banks were less responsive than member banks in response to both tightness and ease in monetary policy although the non-member banks actually resembled country member banks in loan and investment trends, the difference in trends largely supplied by the larger banks in reserve and central reserve cities. Warburton concluded:

> "The conclusion to be drawn from the data regarding the relative importance and comparative rates of expansion of members and non-member banks is that the presence of non-member banks has had little impact on the effectiveness of monetary policy, understood in the sense of

"quantitive monetary control. The non-member banks hold too small a proportion of the assets and deposits of all commercial banks, and their behavior in expanding loans, or loans and investments, under varying degrees of monetary restraint or ease has too much similarity to that of country member banks, to hamper the effectiveness of monetary policy.

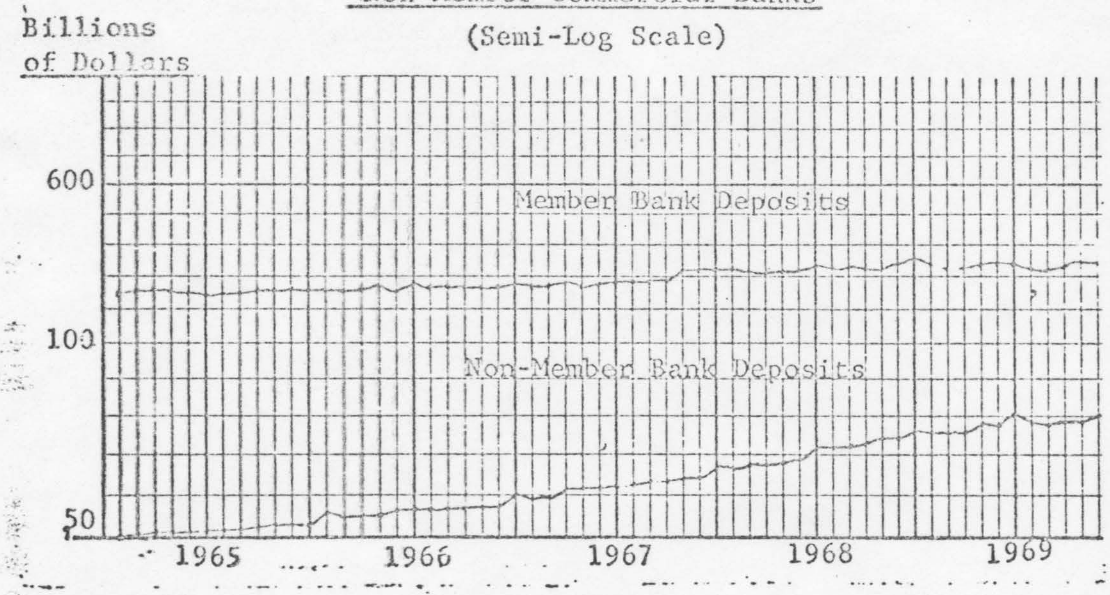
But though this has been true in the past, it might be otherwise in the future. The experience of the future may be different if incentives exist, hitherto largely unused, for member banks to become non-member banks, or for an accelerated rate of expansion of non-member banks relative to country member banks".1/

Warburton's data ended with 1959 and since that time it is relevant to examine if the warnings Warburton gave were justified. Chart I indicates

Chart I

Deposit Growth of Member and Non-Member Commercial Banks

(Semi-Log Scale)



1/ Clark Warburton, "Non-member Banks and the Effectiveness of Monetary Policy", in Monetary Management, Commission on Money and Credit, Prentice Hall, 1963. p.339

the course of all Federal Reserve member and all non-member banks' deposits since 1965. As may be seen, non-member bank deposits have expanded at a substantially greater rate of growth than have member bank deposits. It is interesting to note that non-member deposits now account for about one-sixth of all commercial bank deposits while mutual savings bank deposits plus non-member commercial bank deposits constitute nearly one third of present commercial bank deposits.

Reserve Requirements

Inevitably the question of monetary control brings up the subject of reserve requirements. The crucial distinction between commercial banks (member banks) and intermediaries is the presence for the former institution of rigidly imposed reserve requirements satisfied with only one type of asset (with the minor exception of vault cash) and the absence of any but token reserve requirements for the latter type of institution.

There has been a fairly long history of controversy over reserve requirements for non-member banks and for financial intermediaries. While the Banking Act of 1933 contemplated that all insured banks would become member banks, small banks were exempted by the Banking Act of 1935 and the deadline for the remainder was postponed until it was finally repealed in 1939. The Commission on Money and Credit in 1961 recommended that all insured banks be required to be members of the Federal Reserve System citing the belief that the system of non-member reserve requirements permitted "some escape from the influence of monetary policy". On the other hand, the Commission found that the increase in money substitutes from intermediaries had played a role in speeding the rise in money velocity but the contribution to cyclical changes was too small to warrant extension of direct Federal Reserve control over non-bank financial institutions.[1]

In 1963 the Committee on Financial Institutions consisting of Cabinet and other government officials, concluded that neither non-member banks' reserve ratios nor the supply of reserves on which they draw is uniquely determined by the Federal Reserve. Thus, a portion of the money supply is out of control of the System and while there had been few important short-term fluctuations from the course of member bank deposits, the Committee noted non-member banks had grown faster than member banks and potentially the option of withdrawal from membership represented a constraint of Federal Reserve actions. While the Committee found compulsory membership likely to provide needless controversy, they did conclude that all banks should be subject to reserve requirements specified by the Federal Reserve.

The Committee found it much more difficult to determine whether reserve requirements were desirable for savings and loan associations and mutual savings banks. The problem was approached by examining the necessity of reserve requirements on time deposits at commercial banks noting that while reserve requirements at non-bank intermediaries were not presently essential to monetary policy, they could serve as a supplement and there were liquidity, equity and supervisory considerations making such a measure useful. Accordingly, a recommendation was

1/ Money and Credit, Report of the Commission on Money and Credit, Prentice Hall, 1961, pp.76-81.

made for the "introduction of a similar reserve requirement" for shares at savings and loan associations and deposits at mutual savings banks.1/ It has been contended elsewhere that reserve requirements of existing types do not place a real limit on the capacity of intermediaries to extend credit, only the proportion of funds that can be loaned.2/

The recommendation for all banks to be subject to reserve requirements (though not through compulsory membership) has been contained in the Annual Report of the Board of Governors of the Federal Reserve System for the years since 1964. As late as April 1968 Governor Andrew Brimmer called for Federal Reserve authority to set reserve requirements for all banks, citing the need to strengthen control of the monetary base by the nation's central bank. According to Governor Brimmer, 21 percent of private demand deposits were, in 1967, held by non-member banks against 16 percent at the end of 1956, both weakening the degree of control and making the burden of monetary restraint to fall heavier on the remaining member banks "since non-member banks' private demand deposits (which are also part of the total money supply) do not respond directly to the Federal Reserve's general instruments of credit control".3/

1/ Report of the Committee on Financial Institutions to the President of the United States, U.S. Government Printing Office, April 1963, pp.6-18.

2/ Clay J. Anderson, Recent Trends in Monetary Thought: Implications for Monetary Policy and Commercial Banking. American Bankers Association, 1969, pp.16-18.

3/ Governor Andrew Brimmer, "The Rationalization of Commercial Bank Reserve Requirements", paper presented before the 67th Annual Convention of the National Association of Supervisors of State Banks, 1968.

The problem of reserve requirements enters into the present proposals in Connecticut and by the Home Loan Bank Board because it can be questioned whether the provision of legally required reserves would make the monetary policy aspects of checking accounts at non-bank intermediaries unimportant. The Connecticut proposal would treat mutual savings banks as non-member banks, allowing them to keep the required reserves at a correspondent bank. Whereas up to now Connecticut mutual savings banks on making loans could assume immediate outflow of the entire amount of such loans through checks cleared through their commercial bank account, with the authorization of checking accounts, Connecticut mutuals could begin to enjoy in a limited way multiple credit expansion particularly if deposits could be offered to other banks and business firms. Since the mutual savings bank system is virtually as large in Connecticut as the commercial banking system, the possibilities of an unwanted credit expansion are not inconsiderable. Such a multiple expansion of deposits might be further encouraged by wide consumer loan powers on the part of mutuals. We could foresee demand deposits at intermediaries being important for building firms and construction personnel particularly if real estate loans were tied to the requirements that a deposit be created. The leakage process might then not be such an automatic limitation to credit expansion.

Above all to avoid expansions and contractions of money outside the control of the monetary authorities, if the new proposals are approved and implemented, non-banks should be required to keep reserves in the form of deposits at Federal Reserve banks. The so-called liquidity reserves presently imposed on savings and loan associations which may be fulfilled by Treasury or agency securities, do not act to limit the loans such institutions make, they merely assure a division between desired and less desired assets. The real limit on intermediaries will still be their ability to attract deposits, either savings deposits or the new limited checking accounts.[1/]

Since the reserves of non-member banks are held in the form of deposits in member banks it is sometimes contended that the drift away from membership in the Federal Reserve (and by analogy, the growth of non-bank intermediaries) acts to increase the leverage the Federal Reserve System has on the economy. A given dollar of open market purchases or sales or a given percentage point change in member bank reserve requirements will support (or withdraw support from) a greater volume of monetary and near-money assets than if all banks were Federal Reserve member banks and there were no non-bank intermediaries. This argument reductio ad absurdum implies the best monetary control would be obtained if only one bank were a Federal Reserve member.

We contend the "greater leverage" argument has no real relevance since neither the volume of reserves nor the percentage change in requirements has any real cost to the Federal Reserve. Thus, the proper Federal Reserve move to bring the money supply, credit availability or interest rates into conformity with current or prospective economic conditions may mean a $50 million or a $500 million increase in bank reserves. To the Federal Reserve the difference is one of bookkeeping, not of loss of resources that would be used elsewhere.

1/ Clay J. Anderson, loc. cit.

This analysis of reserve requirements suggests then, the availability of a new source of multiple credit expansion is not a matter that the monetary authorities can ignore with impunity. As new sources of credit and payments media appear, the Federal Reserve is reduced to measures that have a greater impact on commercial banks that are members of the System since their impact on non-member banks and non-bank intermediaries can only be at second (and third) hand by affecting the total money available to be deposited in them and all other depositories. The result is a "stop-go" policy on those sources of credit furnished directly by commercial banks which, in turn, means relative instability in money supply growth with consequent effects on economic growth. This process is made more likely by the new proposals since they enlarge the area of credit and money not directly controlled by the Federal Reserve. While commercial banks as compared with intermediaries are undoubtedly better able to withstand the effects of changing ability to create credit as monetary policy responds to economic conditions, an increase in the degree of policy fluctuation affecting commercial banks (as would be the effect of "monetizing" non-bank intermeiary claims) will lead to greater variability in the money supply with consequent harmful effects on the economy. It would also increasingly make monetary policy the hand maiden of the activities of non-bank intermediaries, forcing all the adjustment to take place in other parts of the financial system. This would seem to be a particularly unfortunate turn of events in an area of economic control already suffering from considerable uncertainty as to policy direction and effects.

Conclusions

This paper has attempted to demonstrate that non-bank intermediaries, if granted limited or general powers to make payments transactions services available to their customers, could increase the volume of demand deposits, alter the present division between demand and time deposits or could affect the velocity of savings. It has been demonstrated that the addition of mutual savings bank deposits and savings and loan shares improves the correlation of demand deposits of commercial banks to economic activity lagged nine months. This suggests they have an important causative relationship to the rate of economic activity. Since these institutions are unimpeded by reserve requirements in the commercial bank sense, the monetary authorities apparently already lose some of their effectiveness in controlling the expansion of credit. If these intermediaries gain additional powers that, in effect, allow them to assume a role in the monetary and payments system it seems likely that further problems of central bank control will arise. Accordingly, there are definite monetary policy implications contained in the proposal. The analysis, hence, suggests that under the existing regulatory powers, the addition of forms of checking account functions to mutual savings banks and savings and loan associations cannot be a matter of indifference to the Federal Reserve System.

THOMAS J. LENNON
PRESIDENT

DANIEL H. H. INGALLS
CHAIRMAN

THE
HOMESTEAD
HOT SPRINGS, Virginia 24445
TELEPHONE 839-5500

April 28, 1970

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

Re: INTERNATIONAL MONETARY CONF.
May 17 - 20

REVISED RESERVATION

Dear Mr. Burns:

We take pleasure in confirming your request for reservation as follows:

Name: The Honorable Arthur Burns

Arrival: May 17

Departure: May 20

Accommodations: Parlor, double room with twin beds and bath

Rate: $21 or $25 daily for parlor; $51.00 daily, American Plan for double room for single occupancy

Remarks: We note you are to be a guest of the conference
Your account will be charged to them

We appreciate this booking and hope that your forthcoming visit will be most enjoyable.

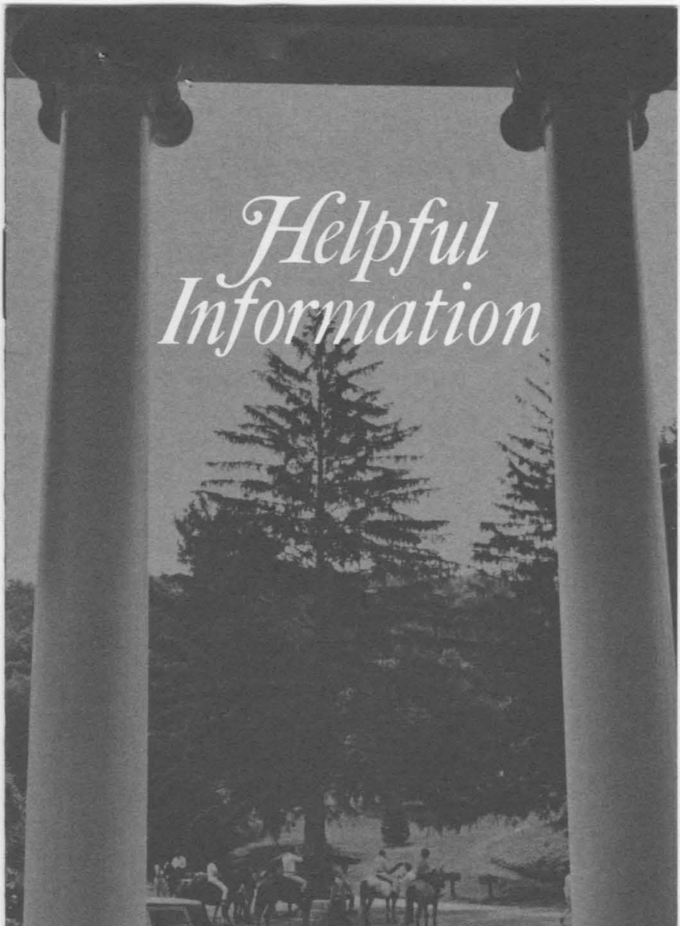
Yours sincerely,

THE HOMESTEAD

Robert N. Harris, Jr.

Robert N. Harris, Jr.
Reservation Manager

pm
cc: Mr. Roy W. Terwilliger



Helpful Information

THE
HOMESTEAD
HOT SPRINGS, VIRGINIA 24445
TELEPHONE (703) 839-5500

How to find your way around...

For the convenience of our guests a panoramic layout of The Homestead is available at the front desk. This shows sports facilities, shops, function rooms and public areas. There is also a complimentary map of mountain trails and Cascades stream for hiking, riding and fishing buffs.

Dress...

Casual sportwear is recommended for daytime wear. Walking shorts, mini skirts, slacks and turtleneck shirts may be worn in the dining room for breakfast and luncheon. Tightfitting and abbreviated attire is not allowed. Gentlemen must always wear jackets while dining. Bathing suits are restricted to the pool area and guests must wear robes over suits when passing through the hotel. Young ladies can wear contemporary bathing suits. *Evening Wear:* Most of our guests wear formal attire, but this is not required. Cocktail or dinner dresses for women and dinner jackets for men predominate.

Tipping...

This is a matter that each guest decides for himself. Most groups who meet at The Homestead arrange to have a percentage of the daily American Plan rate charged to each member's account to cover normal gratuities.

However, individual guests do ask occasionally what is customary at The Homestead and we present the following suggestions:

Dining room waiters: Breakfast 40¢, luncheon 60¢, dinner $1.00.

Bellmen: 50¢ for each piece of luggage.

Maids: $1.00 per day per room.

Doormen, dining room captains and butter girls, bath house attendants, etc., according to the service they render.

Activities & Facilities

GOLF Three 18-hole courses. Homestead Course with putting green and practice fairway near Casino. Cascades Course and Lower Cascades Course nearby with free bus service to and from both courses. Golf carts available all three courses.

TENNIS Eight courts, one all-weather court.

RIDING Horseback and Carriage.

SWIMMING Indoor and outdoor pools and sun beach. Warm Springs Pools.

SKEET & TRAP Four fields N.S.S.A. specifications.

FISHING Cascades Stream open to guests during Trout Season.

BOWLING Eight tenpin alleys. Automatic pin setters.

ICE SKATING November through March.

SKIING December through March. Ski lifts, trails and slopes are right on the Hotel grounds.

LAWN BOWLING Adjacent to the Casino.

HIKING Attractive graded walks and several miles of paths are accessible to hikers on our 17,000-acre estate.

SPA Famous mineral baths and massage. Home of Countdown Club.

INDOOR GAMES Ping-Pong, Dance Studio, Billiards ... Spa Building.
Bridge, Canasta and Backgammon.

TELEVISION Tower Lounge.

MOVIES Nightly at 8:45, Sunday 9:15.

DANCING Homestead Club, nightly except Sunday.

HOMESTEAD GRILLE A la Carte dining, dinner and supper, 7:00 P.M. to 1:30 A.M., nightly. (Closed During Winter Season)

CHILDREN A supervised playground and indoor playroom is available for younger children.

ENTERTAINMENT Concerts daily. Movies nightly. Dancing nightly except Sunday.

STENOGRAPHER Call Operator for services of public stenographer.

PHOTOGRAPHER Call Operator for services of professional photographer.

DRUGSTORE Prescription and proprietary drugs.

EXERCISE ROOMS Zander Gymnasium, Spa Building.

CARRIAGE RIDES Buckboard, fringe topped surrey rides available for your pleasure.

EQUIPMENT RENTAL Rental of equipment for all sports, including jodhpurs, jodhpur boots, fishing tackle, swimsuits, ice skates, skiing and golf equipment.

Getting to The Homestead

TRAIN The Chesapeake and Ohio Railway provides service from principal cities of the East and Midwest to Covington, Virginia, our mainline station. All tickets should read to Hot Springs, Virginia, and the railroad will provide limousine transportation between Covington and The Homestead at no additional charge.

AUTOMOBILE U.S. Route No. 220, a modern high-speed highway, runs north and south through Hot Springs. Motor distance to Hot Springs from some principal cities is approximately as follows: New York, 440 miles; Cincinnati, 350; Washington, 200; Cleveland, 370; and Roanoke, 80 miles.

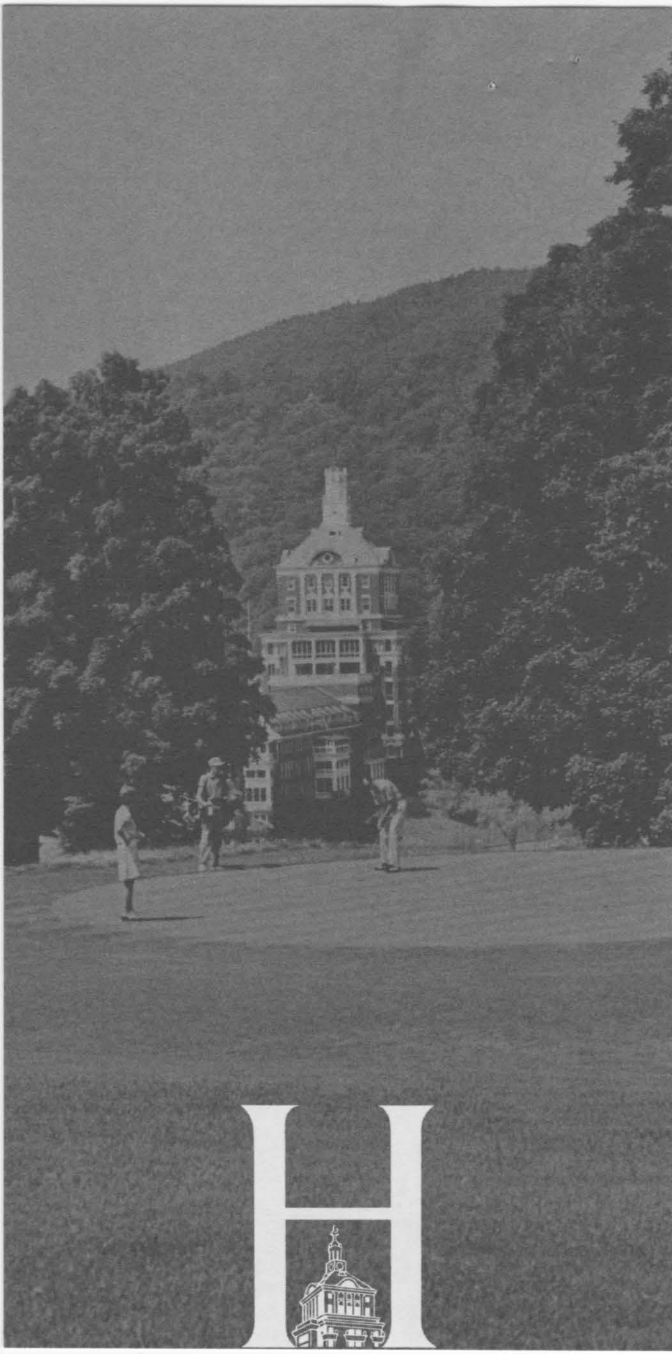
AIRPLANE Piedmont Airlines now serving Ingalls Field with convenient daily commercial schedules. Air taxi and charter service to and from Ingalls Field easily arranged. Ingalls Field, located atop Warm Springs Mountain, elevation 3,800 ft., 17 miles from The Homestead by new paved access highway, now has a 5,600-ft. bituminous concrete paved runway equipped with medium intensity taxiway and runway lights, 36″ rotating beacon, abbreviated visual approach slope indicator lights and runway end identifier lights runway 6-24. Modern terminal facilities, can now serve most all types of private and corporate aircraft.

Navigational aids include a 36″ rotating beacon, a new non-directional radio beacon (H Marker -224Kc, Identification HSP), Zone marker beacon (75Mc, Identification A) and Unicom (122.8), all operating continuously and located right on the airport. 80/87, 100/130 octane aviation gas and type A-1 turbine fuel available.

THE
HOMESTEAD
HOT SPRINGS, VIRGINIA 24445

TELEPHONE (703) 839-5500

30M—S—2-70



PIEDMONT AIRLINES

DIRECT AIR SERVICE

TO

HOT SPRINGS, VIRGINIA

Piedmont Airline Service Direct to Hot Springs, Virginia
April 26, 1970
Eastern Daylight Time

FLIGHT 984 (Daily)
YS11 Prop-Jet

Lv Knoxville	7:10 A.M.
Ar Roanoke	9:28 A.M.
Lv Roanoke	9:50 A.M.
Ar Hot Springs	10:10 A.M.
Lv Hot Springs	10:20 A.M.
Ar Washington (National Airport)	11:11 A.M.
(Limousine leaves for Ingalls Field)	9:10 A.M.

FLIGHT 908 (Daily)
YS11 Prop-Jet

Lv Cincinnati	9:45 A.M.
Ar Roanoke	12:20 P.M.
Lv Roanoke	12:43 P.M.
Ar Hot Springs	1:03 P.M.
Lv Hot Springs	1:15 P.M.
Ar Charlottesville	1:42 P.M.
Lv Charlottesville	1:57 P.M.
Ar Washington (National Airport)	2:32 P.M.
(Limousine leaves for Ingalls Field)	11:45 A.M.

FLIGHT 959 (Daily)
YS11 Prop-Jet

Lv Washington	12:00 Noon
Ar Staunton	12:43 P.M.
Lv Staunton	12:58 P.M.
Ar Hot Springs	1:23 P.M.
Lv Hot Springs	1:35 P.M.
Ar Roanoke	1:57 P.M.
Lv Roanoke	2:15 P.M.
Ar Cincinnati	4:57 P.M.
(Limousine leaves for Ingalls Field)	12:20 P.M.

FLIGHT 939 (Daily)
YS 11 Prop-Jet

Lv New York(LaGuardia)	7:15 P.M.
Ar Washington	8:40 P.M.
Lv Washington	8:55 P.M.
Ar Charlottesville	9:26 P.M.
Lv Charlottesville	9:40 P.M.
Ar Staunton	9:58 P.M.
Lv Staunton	10:10 P.M.
Ar Hot Springs	10:35 P.M.
Lv Hot Springs	10:47 P.M.
Ar Roanoke	11:09 P.M.
(Limousine leaves for Ingalls Field)	9:45 P.M.

INDEPENDENT LIVERY provides limousine service to all flights.

One passenger	$6.00
Over one passenger, each	3.50

This price includes Baggage.
No charge for children under six years.