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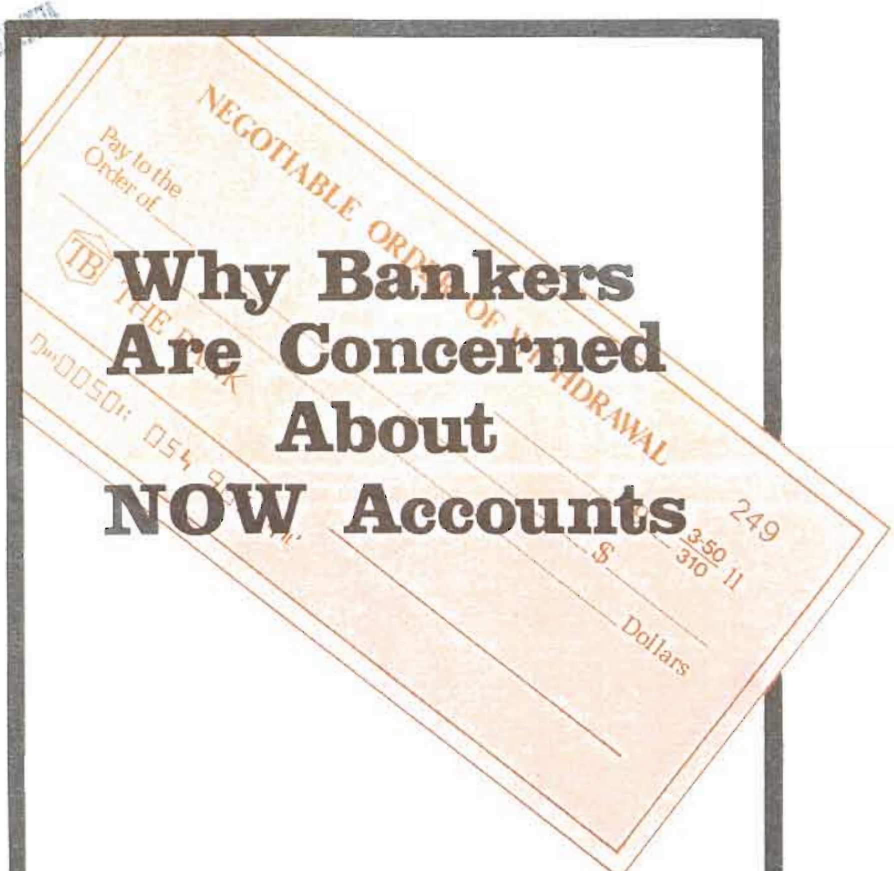

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and

Commodity Agreements: The Haves vs. The Have-Nots?

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WHY BANKERS ARE CONCERNED ABOUT NOW ACCOUNTS

Howard Keen

. . . NOW accounts may not be a picnic for commercial bankers, but they aren't likely to be as damaging as many bankers fear.

COMMODITY AGREEMENTS: THE HAVES VS. THE HAVE-NOTS?

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. . . The developing countries want agreements that will give them higher-than-market prices for the raw materials they export. The author suggests that these agreements might not produce the expected benefits and proposes other ways to encourage economic development.

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Why Bankers Are Concerned About NOW Accounts

By Howard Keen*

If your local banker seems a bit preoccupied these days, don't be surprised. Chances are he's concerned that the competitive world as he's known it may be coming to an end. In that world, the law gave commercial banks a near monopoly on checking accounts. But pressure for reform may introduce a change in America's financial system which would sweep away the checking monopoly.

This change is the authorization of negotiable order of withdrawal (NOW) accounts for commercial banks and other financial institutions throughout the country. NOW accounts are interest-bearing checking accounts for nonbusiness depositors. They currently are authorized in New England, and proposals in Congress would extend them nationwide.

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Advocates of NOW accounts claim that consumers will benefit from them, but bankers worry that these gains will be at their expense. A look at how NOW accounts might affect commercial banks reveals why bankers are showing this concern, and why some are showing more than others. It also suggests, however, that NOW accounts may not be the disaster that many bankers fear.

BATTLING FOR BUCKS

NOW accounts are sure to affect competition for family funds. Households ordinarily keep funds they want to have readily available in three basic forms—currency, checking accounts, and savings accounts. The three together come to about $1 trillion—a tidy sum. Currency and checking accounts are most convenient for making payments, but they have their drawbacks. Carrying large sums of cash can be risky, and funds that are held as cash or in checking accounts earn no explicit interest.[1] By contrast, a savings account may be less convenient for making payments but it produces interest income for its owner; and it's relatively safe.

How family funds are divided among these forms depends on the tradeoffs people make among safety, convenience, and interest income. If, for example, it became much easier to switch funds from savings to currency or checking accounts, we would expect to see more funds held in savings accounts and less in currency and checking. Thus, in effect, currency competes against savings and checking accounts for household funds.

Commercial Banks and Their Rivals. Different *financial institutions* also compete for household funds. Savings accounts, for example, can be held both at commercial banks and at thrift institutions such as mutual savings banks (MSBs), savings and loans (S&Ls), and credit unions (CUs). With some exceptions, checking accounts can be held only at commercial banks, but there is a host of commercial banks to choose from. Thus, in trying to attract funds into checking accounts or savings accounts, commercial bankers face competition on two fronts. First, they compete as a group against currency and against savings accounts at thrifts. Second, they compete among themselves for the de-

[1] For an analysis of the comparative advantages of currency and checking accounts, see Donald L. Kohn, "Currency Movements in the United States," *Monthly Review*, Federal Reserve Bank of Kansas City, April 1976, pp.3-8.

HOW CONSUMERS MIGHT GAIN FROM NOWs

NOW accounts might bring several benefits to consumers.

First, consumers could hold a checking-type account at many more financial institutions than they can now. And this wider choice could save them time and effort. Being able to bank at a thrift located around the corner instead of at the nearest commercial bank 10 blocks away makes more time available for other activities. Even where banks and thrifts were equally convenient, consumers could avoid the costs involved in switching funds from savings to checking—as they must do now if they want to earn interest on their spendable funds. By offering a savings and checking account rolled into one, NOW accounts could save consumers the time, hassle, and monetary costs of this kind of transaction.

Further, consumers could gain more from the payment of explicit cash interest than from implicit interest in the form of banking services. As more and more banking services are provided to depositors, they tend to get less additional benefit from further increments of these services. Cash, however, can be used to purchase other, preferred goods and services. The total value that depositors receive could be higher if interest payments were substituted for some banking services.

Consumers could benefit also from the more intense competition of financial institutions that NOWs would permit. These gains are likely to be larger during the intitial phase of NOW accounts when banks and thrifts are trying to establish their market shares. Even after market shares stabilize, however, competition could result in consumers' receiving more for their funds than before.

It's likely that opportunities for gains would be different for different consumers. Depositors pay no taxes on banking services as they do on cash interest received, and this tax difference can affect the comparative values that consumers attach to these two forms of payment. The higher the depositor's marginal tax rate, the less attractive is payment in cash. At the same time, it's possible that some customers might end up paying more under NOWs than before. Depositors who are accustomed to write a lot of checks while holding low balances, for example, could find that continuing to do so would cost them more in service charges than they receive in interest.

posits that households might decide to hold at commercial banks.

Nature of Checking Account Competition. The law has given commercial banks an inside track in the competition for household funds. Most of the money Americans spend is spent by check, and commercial banks have been nearly the only institutions allowed to provide the checks. Their monopoly on checking accounts has made it easier for them to attract nonchecking deposits, because it's more convenient for the consumer of bank services to handle all his transactions at one institution. Only those who can afford the inconvenience are likely to be won over by the higher maximum interest rate allowed on savings at thrifts.[2]

But while banking is competitive, it's also regulated, and so bankers can't compete freely. They're barred, for example, from paying interest on checking accounts, and they have to cope with interest-rate ceilings on savings accounts. Thus about the only way they can compete is by providing more services, such as free or subsidized checking, to their customers These services cost the banker something, and in many cases his costs are greater than the service charges that depositors pay. So an inducement is being paid for checking account dollars, but it's in the form of banking services rather than cash.[3]

Nonetheless, the restrictions on entry into this checking account market may have allowed some banks to attract funds at a lower average cost than if they had to compete against other bidders. And by helping to keep costs down, the restrictions may have given a boost to bank profits.

WHAT NOWs COULD DO

NOW accounts, as authorized in New England and as proposed in Congress for the rest of the country, are considered in law to be savings accounts.[4] But the negotiable orders of withdrawal are, in essence, checks, so that for all practical purposes, NOWs are interest-bearing checking accounts. Under the proposals to legalize the extension of these accounts nationwide, all depository institutions could offer what amounts to a checking account, and commercial banks, as well as the rest, would be allowed to pay interest on these accounts. Since these proposals would eliminate the checking account monopoly as well as the prohibition against paying interest on checking accounts, it's likely that commercial banks would feel some impact. As it turns out, bank profits could be affected by NOW accounts in several ways.

NOWs Could Cut Bank Costs . . . One of the key features of NOW accounts—permission to pay interest on checking accounts—might tend to lower the costs of some banks. Why? Because banks probably can attract a certain volume of funds at a lower cost if they can pay for them with interest in cash than if they have to pay for them with banking services alone. The reason is that, at some point, paying interest becomes cheaper than providing bank services.

As the depositor is provided more and more of a service, the value to him of each further bit of the service goes down. People may find it valuable, for example, to receive a statement every month which lists their deposits and checks written. But getting a

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[2]Regulations on passbook savings accounts, for example, set the ceiling a quarter of a percentage point higher at MSBs and S&Ls than at commercial banks. CUs are subject to different regulations which permit even higher rates to be paid.

[3]For a discussion of this implicit interest, see John H. Boyd, "Household Demand For Checking Account Money," *Journal of Monetary Economics* 2 (1976), pp. 81-98. and James M. O'Brien, "Interest Ban on Demand Deposits: Victim of the Profit Motive?" *Business Review*, Federal Reserve Bank of Philadelphia, August 1972, pp. 13-19.

[4]Since reserve requirements are lower for savings than for checking, this legal classification of NOW accounts will reduce the reserves that banks are required to hold.

statement every three weeks, then every two, and then every week, probably would be of little value to most depositors. By the same token, many customers would find the extension of closing time from six o'clock to seven o'clock a useful added attraction But each further hour tacked on probably would be valued less than the last. This characteristic—that each added unit of a service contributes less to total consumer satisfaction—is not unique to banking. In fact, it holds after some point in all kinds of business.

Further, after some level of services is reached, the bank will have to spend more than a dollar to give depositors extra services which they will value at a dollar. As the bank uses more and more resources to provide banking services, and as the cost for each additional unit of service rises, it becomes increasingly expensive for the banker to attract checking account funds or to hold on to them in the face of added competition. Thus a bank may find that it can retain or attract depositors at a lower cost if it pays for funds with interest rather than with more and more services. In short, having the option of paying depositors with cash rather than with banking services may be a valuable weapon for banks in their competitive struggle for funds.[5]

. . . But NOWs Also Could Boost Costs. The road to lower costs, however, is not without its potholes. In fact, bankers could find that NOWs tended to inflate costs.

In the first place, banks can't realize the benefits of paying cash interest overnight or by standing pat. If banks which are providing services at no charge to depositors hope to attract the same amount of funds at a lower cost, they must do two things. In addition to paying their depositors explicit interest, they must institute an appropriate charge for services they previously provided for free. But discovering the right combination of interest rates and charges may take time.

BOX 1

SOME ALTERNATIVES TO CHECKING ACCOUNTS AT COMMERCIAL BANKS

The following are the most frequently discussed thrift institution alternatives to commercial bank checking accounts:

Bill-Paying Services	— Payment of bills by direct transfer of funds out of thrift savings accounts. In preauthorized version, thrifts automatically pay bills on regular basis after initial authorization by consumers. In telephone version, consumers telephone thrifts each time a payment is desired.
Off-Premise Electronic Terminals	— Deposit and withdrawl from thrift savings account at off-site location. In some cases, consumers can make direct transfers from own to merchants' accounts.
Share Drafts	— Check-like payment from credit union deposit or share accounts.
Checking Accounts	— Traditional checking account transactions (noninterest-bearing NOWs—NINOWs).

[5] Tax considerations can play a role in the way that depositors value cash and services. The fact that no taxes are levied on services would make this form of payment more attractive to depositors than it would be otherwise.

And during the transition, bankers may be spending more, rather than less, to attract the same amount of funds.

Further, removal of the ban on cash interest could heat up the battle for funds. Banks would be able to compete by offering interest as well as services. If each bank in the market were to pay only cash and to provide no free services, it's possible that the costs of each and every bank would fall. But the individual banker can't be sure that his rivals will do as he does. And the actions of his rivals can affect his profits. A banker who decides to continue offering free services and paying no interest while his rivals offer both services and interest may have to revise his decision rather quickly to avoid losing deposits. Thus his profits, as well as those of his rivals, might turn out to be less than if every bank paid only cash interest.

So removal of the ban on cash interest, while providing an opportunity for lower costs, also provides an opportunity for rival banks to offer more for deposits. No banker would intentionally offer a package that would cut into his profits, but his rivals could offer a package that would do the job for him. It's possible that banks may compete away some profits because each and every banker wants to protect himself against the possibility of losing even greater profits. And while there is no way to tell with any precision to what degree this might occur, the mere prospect that it might is enough to worry many bankers.

Finally, because NOWs would allow thrifts to offer checking account services to consumers, it would be easier than before for these institutions to compete with commercial banks for funds.[6] More competition would bring about an increased demand for these funds and thus higher interest rates paid to checking account customers (Boxes 1, 2).

In short, commercial banks could feel the effects of NOW accounts in several ways. These might raise but also might lower the average cost of funds to bankers. Unless the efficiency benefits of paying depositors with

BOX 2

HOW WIDESPREAD IS THE AUTHORITY TO OFFER CHECK-LIKE SERVICES?*

Preauthorized Bill-Paying	— Federally chartered S&Ls nationwide.
Telephone Bill-Paying	— S&Ls in 8 states and D. C.; MSBs in 9 states.
Off-Premise Electronic Terminals	— Federally chartered S&Ls nationwide; S&Ls in 20 states; MSBs in 10 states; Federally chartered CUs in 10 states.
Share Drafts	— Federally chartered CUs nationwide; CUs in 27 states.
Checking Accounts	— S&Ls in 6 states; MSBs in 12 states; CUs in 3 states.

*Establishment of the authority for these services does not guarantee that they actually are being offered at the present time.

SOURCE: American Bankers Association press release of June 14, 1977.

[6] NOW accounts do not provide the only opportunity for thrifts to offer checking account services. Changes in payments technology along with regulatory rulings and interpretations already have given thrifts the authority to enter what was exclusively a commercial bank domain.

cash outweighed any higher costs brought about by increased competition, the average cost of funds to commercial banks would rise.

SOME BANKS HAVE MORE AT STAKE

Bankers have no way to predict the net impact of NOW accounts with any precision. But with the competitive rules of the game changing, no prudent banker can avoid being concerned to some degree. And on top of this, there are certain conditions that make some bankers more apprehensive than others.

Sources of Funds Make a Difference. Since NOW accounts apply to nonbusiness deposits only, banks that rely to a greater extent on households for their sources of funds would be affected more by changes in costs for these deposits. The greater the percentage of total funds that comes from households, the greater any impact of NOW accounts on bank costs.

Smaller banks typically rely more on these household sources. According to a 1976 Federal Reserve survey, nonbusiness checking account funds made up 41 percent of the total at small banks, 37 percent at medium-sized banks, and 25 percent at larger banks. A similar pattern holds for the ratio of household checking deposits to total deposits.[7] Because of this heavier reliance on nonbusiness deposits, many smaller banks would experience a bigger percentage change in costs than larger banks. The heavier this reliance, the greater the impact on a bank's total cost of funds from a change in the cost of nonbusiness deposits. On average, then, smaller banks stand to gain or lose more from NOW accounts than do larger banks.

Degree of Competition Matters, Too. Banks that face little competition for household funds under the current system also have more to lose from NOW accounts. All things considered, these banks pay less for personal funds than they would if the market were highly competitive. This helps keep costs down and gives them larger profits. The greater are a bank's profits that arise from paying less than competitive rates for these funds, the greater are the profits that might be eliminated through additional competition.

Thus banks in less competitive deposit markets have more to lose from additional competition than do banks where competition is stronger. Although the degree of competition can vary greatly among the local markets, banking markets in areas with larger populations tend as a rule to be more competitive than those in areas with smaller populations.[8] Overall, then, smaller banks in less populated areas have more at stake when it comes to NOW accounts. This does not mean that banks with these characteristics are guaranteed a worse time than other banks.[9] Nevertheless, having more at stake is enough reason for added concern over an uncertain outcome.

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[7]See *Functional Cost Analysis: 1976 Average Banks,* p. 7.6, and "The Impact of the Payment of Interest on Demand Deposits," Board of Governors of the Federal Reserve System, January 31, 1977, p. 48.

[8]See "Recent Changes in the Structure of Commercial Banking," *Federal Reserve Bulletin,* March 1970, pp. 195-210.

[9]Profits are affected by the demand for loans and by the aggressiveness of competing institutions as well as by costs. All things considered, the more inelastic is the demand for loans, the less will be the reduction in profits from some given increase in costs. At the same time, a bank's cost of funds will be pushed up less, the less aggressive are competing institutions in offering NOW accounts. For an analysis of the decision to offer NOW accounts by MSBs as well as by commercial banks, see Donald Basch, "The Diffusion of NOW Accounts in Massachusetts," *New England Economic Review,* November/December 1976, pp. 20-30. As Basch's analysis shows, predicting the behavior of financial institutions is no easy task. There is another feature of less competitive markets, however, that could make the road rougher for commercial banks. It's possible, for example, that entry by thrifts may be encouraged by lower rates paid to depositors by commercial banks. Since these rates would be lower in less competitive deposit markets, banks in these markets may feel stiffer competition from thrifts.

LESSONS AND PROSPECTS

Although nationwide NOWs could make life tougher for some bankers, it's difficult to predict just how much tougher. Against the opportunity for more intense competition and its likely impact on bank costs is the prospect of a gain in efficiency from paying depositors with cash. Moreover, what bankers do in terms of charging for services and how aggressively thrifts enter the market for NOWs will have an important bearing on the outcome.

NOWs in New England. Commercial banks and thrifts (except CUs) have had the authority to offer NOW accounts in Massachusetts and New Hampshire since 1974 and in the rest of New England since 1976. Several studies have been done to try to estimate the impact of NOW accounts on commercial banks there. For the most part, these studies have focused on Massachusetts and New Hampshire, since NOWs have been authorized in these two states for the longest time.

It's been estimated, for example, that for all banks in these two states, NOW accounts reduced after-tax earnings by about two and a half percent in 1974 and by a little over eight percent in 1975.[10] Within this aggregate group of banks, however, were some that experienced larger percentage declines in earnings. One group of banks with low earnings to begin with, and another group that chose not to offer NOWs and experienced a runoff of deposits, were particularly hard hit. Out of 226 banks in the two states, 16 were in the former group and 15 in the latter. Another study examined the 22 Massachusetts banks with negative earnings in 1976 and concluded that these negative earnings were not explained by the percentage of total deposits in NOW accounts.

In short, it appears that while some banks have had a lot of adjusting to do, NOWs overall have not severely damaged the position of commercial banks in New England.

NOWs in the Rest of the U.S. While bankers may not find complete reassurance in the estimated impact of NOWs in New England, there are reasons to believe that banks in the rest of the country may not find the going as rough.

For one thing, bankers have the New England experience to learn from. And if the learning that comes from the inevitable trial and error is costly, then bankers in the rest of the U.S. may be able to avoid some costly mistakes. One lesson, for example, is that the pricing of NOW accounts is of prime importance. Whether NOW accounts are profitable or unprofitable can depend upon the pricing package that bankers devise. A comparison of banks in Massachusetts in 1976 showed that banks that offered NOWs with service charges had average earnings rates almost double those of banks not offering NOWs. A third group—the one with banks offering free NOWs—had the lowest. Banks do not have to pay depositors more for their funds than banks can earn on them, and the proper pricing structure can help banks avoid losing money.

Another lesson from New England is that the transition period described earlier may not last more than a few years. In Massachusetts and New Hampshire, aggressive competition for NOWs was beginning to ease a bit less than two years after the introduction of NOWs. And with the New England experience to learn from, it may be shorter elsewhere.

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[10] For estimates of the impact of NOW accounts on all commercial banks in Massachusetts and New Hampshire, see John Paulus, *Effects of "NOW" Accounts on Costs and Earnings of Commercial Banks in 1974-75*, Staff Study No. 88, Board of Governors of the Federal Reserve System, 1976. Estimates of the impact on particular groups of banks are given in Ralph C. Kimball, "Impacts of NOW Accounts and Thrift Institution Competition on Selected Small Commercial Banks in Massachusetts and New Hampshire, 1974-75," *New England Economic Review*, January/February 1977, pp. 22-38. See also U.S., Congress, Senate, Subcommittee on Financial Institutions of the Committee on Banking, Housing, and Urban Affairs, *NOW Accounts, Federal Reserve Membership, and Related Issues: Hearings on S.1664, S.1665, S.1666, S.1667, S.1668, S.1669, and S.1873*, 95th Cong., 1st sess., 20, 21, 22, and 23 June 1977, pp. 1124-1133.

A stronger position in the competition with thrifts likewise may ease the cost pressures on bankers. There is some evidence on depositor loyalty which suggests that many depositors may prefer to hold a NOW account at an institution they've dealt with in the past. Although thrifts have an interest-ceiling advantage on savings, locational convenience and a wider menu of financial services still are strong selling points for commercial banks. If customers stay loyal, then current shares of savings may indicate how competitive banks might be in the struggle for NOW accounts. In New England at the end of 1975, banks held only 20 percent of savings deposits and of time deposits totaling $100,000 or less, while thrifts held 80 percent. Nationally, however, banks are in a stronger competitive position, with 45 percent of the total compared to 55 percent for thrifts.[11]

Proposals now before Congress (S. 2055 and H.R. 8981) also could serve to ease the earnings pressure that commercial banks might feel from NOW accounts. One proposal is for the Fed to pay interest on required reserves, and a second would allow reductions in the required reserve ratio on certain checking and savings deposits. While nonmember banks in many states have the opportunity to hold their required reserves in earning assets, member banks do not. Payment of interest on reserves and reductions in required reserve ratios would provide added revenue to these banks which could help offset any increase in costs.

A third proposal is designed expressly to help ease cost pressures during the initial phase of NOW accounts. It calls for maximum interest rates on NOW accounts equal to the maximum allowed on passbook savings at commercial banks. The proposal allows, however, for the interest rate ceiling on NOWs to be set below this maximum and then to rise gradually over a period of several years. Such a gradual phase-in procedure would reduce the likelihood of sharp increases in the cost of funds and would give bankers a little breathing room in their search for a desirable pricing plan. A final provision calls for the NOW account package to take effect one year after it is signed into law, and this delay would give bankers additional time to gear up for NOW accounts. Each of these proposals represents another advantage that bankers around the country would have that their New England counterparts did not.

BANKERS' CONCERNS IN PERSPECTIVE

After examining the ways that NOW accounts could affect commercial banks, it seems safe to say that bankers have solid reasons for concern over these new accounts. They are faced with the prospect of paying interest where they paid none explicitly before as well as with the prospect of added competition for funds. Understandably, bankers are worried that all of this will mean higher costs for them.

But several advantages of financial reform could help offset the cost pressures from added competition. Paying interest in cash can be more efficient than paying in the form of bank services. And with an appropriate pricing plan, paying cash interest actually could lower bank costs. Moreover, the initial phase of NOW accounts may be easier than many bankers think. Bankers have the New England experience with NOWs as a guideline, they may be in a stronger competitive position with thrifts than banks in New England, and they might enjoy the benefit of a gradual phase-in of interest ceilings on NOWs. At the same time, member banks may begin to earn interest on required reserves. All of this could help mitigate any higher costs that banks might feel from NOW accounts. Banks in Massachusetts and New Hampshire didn't have any of these advantages, but most of them have fared reasonably well.

In short, while NOW accounts may not be a picnic for bankers, neither are they likely to be as damaging as many bankers fear.

[11] "The Impact of the Payment of Interest," p. 47.