Research Department
Federal Reserve
Bank of
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FRBSF Weekly Letter

NOW Developments

At the end of last year, commercial banks, savings-and-loan associations and other thrift institutions began offering interest-bearing transaction accounts called NOW (negotiable order of withdrawal) accounts. Since then, the nature of the competition for household checking deposits has changed dramatically. No longer are banks and credit unions the only institutions (outside the Northeast) offering interest-bearing transaction accounts. With NOW accounts, savings-and-loan associations for the first time have an opportunity to compete with commercial banks for the checking deposits of households and nonprofit institutions—and they have seized this opportunity aggressively.

In the West, NOW balances have grown at an explosive rate so far this year (see chart). Western commercial banks, like their counterparts elsewhere, have jumped to an early lead in the competition for market share. Western S&Ls, however, have gained a larger market share than their national counterparts, and have also eaten into the lead of their regional banking competitors.

This intense competition will strongly affect banks' as well as S&Ls' profits, particularly as the S&Ls begin to take advantage of their recently expanded asset and liability powers. Ultimately, this competition may cause all depository institutions to reevaluate and reprice the services they offer.

Before NOWs

Banks nationwide have been able to offer a close substitute for interest-bearing transaction accounts since November 1978, when regulatory authorities authorized use of ATS (automatic transfer from savings) accounts. As their name implies, these accounts permit the transfer of funds from a depositor's savings account to cover checks drawn on a linked (usually zero-balance) checking account. ATS balances at first grew at an unever pace, however, because of questions regarding their legality. An April 1979 court ruling set aside the regulations authorizing ATS accounts, and their status remained in doubt until the Monetary Control Act (MCA) legalized such deposits in March 1980.

In overall terms, ATS balances grew substantially until the beginning of 1981 (when many depositors converted their ATS accounts to NOWs), but their growth failed to match the spectacular growth of NOW balances in the first four months of 1981. "Other checkable deposits," which until this year included all ATS balances plus NOW balances at New England, New York and New Jersey depository institutions, reached \$26.9 billion by December 1980. Over the next four months, however, this category jumped to \$64.5 billion—a 140-percent increase—almost entirely because of NOW-account growth.

Competition spurs growth

Many factors contributed to this development, including the greater simplicity of the NOW account as opposed to the ATS account. But another important factor was the S&Ls' entry into the competition for interest-bearing transaction balances. The absence of thrift competition for ATS balances, in contrast, tended to reduce banks' incentives to offer their ATS accounts at attractive terms. In local markets outside New England and New York, many small banks decided not to offer ATS accounts in earlier years because of the probability that their customers would not be lured away by a competitor's ATS service. (By contrast, most of them chose to offer NOW accounts this year.) Most banks offering ATS imposed substantial minimum-balance requirements and aimed their marketing campaigns only at their highest-balance customers, to discourage their zero-interest checking accounts from switching to 5¼-percent-interest ATS accounts.

Since the first of the year, the competition for interest-bearing transaction balances has in-

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tensified considerably as a result of the entry into the market of these new thrift-institution competitors. Commercial banks and thrifts alike, by regulation, cannot exceed a 5¼-percent interest rate on their NOW and ATS accounts. Thus, they have been forced to compete for deposits on the basis of minimum-balance requirements and service packages.

Different incentives
In this competitive environment, S&Ls generally offer the most attractive terms, such as lower minimum-balance requirements and comprehensive packages of related services (free checks, check-guarantee cards, etc.). They do this because, unlike banks, they view NOW deposits as a source of new, low-cost funds. Sixty to sixty-five percent of S&L NOW deposits have come from outside the industry (largely from commercial-bank checking or savings accounts) and not from thrift-institution passbook savings. S&L executives are quite pleased with this development because, in spite of reserve requirements and processing costs, these NOW funds are much cheaper than funds borrowed in the money markets or from Federal Home Loan Banks at rates currently in excess of 15 percent.

S&Ls also have been aggressive in their promotional campaigns because their ability to offer a transaction account allows them to compete with commercial banks as one-stop family financial centers. And since convenience is a primary factor in households' decisions about uses of funds, S&Ls expect to be able to lure other deposits, such as savings accounts, once they have established primary relationships with depositors. In essence, then, S&Ls may be offering attractive NOW-account packages today in anticipation of more profitable overall relationships with depositors in the future.

The pressure of S&L competition has induced commercial banks to offer more attractive terms on ATS and NOW accounts than they did when they were the only competitors in the field. For instance, many now offer lower minimum-balance requirements than they did previously. Despite these "repricing" maneuvers, however, banks generally require higher minimum balances than S&Ls do, partly because they want to discourage their customers from shifting funds to higher-cost NOWs at their own institutions. With this strategy, of course, the banks are gambling that a relatively insignificant proportion of their customers will shift funds to S&Ls. To a certain extent, these differences in terms may also reflect differences in the services offered by banks and S&Ls. Banks generally offer more extensive branch and ATM (automated teller machine) networks, as well as broader packages of consumer financial services. Thus, banks can offer their NOW customers a more comprehensive package of services—albeit at higher cost—than can the S&Ls. As long as households value these other services, banks may not experience a significant decline in market share despite generally higher minimum-balance requirements.

Western trends
In the Western states served by the San Francisco Federal Reserve District, the competition for interest-bearing transaction deposits began to heat up long before this year's introduction of NOW accounts. Late last summer, several large banks cut the minimum-balance requirements on ATS accounts in a successful effort to get a headstart on NOW-account competition. In November and December, depository institutions (especially S&Ls) encouraged depositors to open accounts that would be converted to NOW accounts on January 1. All the larger banks and S&Ls began advertising in earnest in December, and this activity remained intense through February. The intensity of this competition helped raise consumer awareness of the advantages of interest-bearing transaction accounts. NOW balances at larger Western institutions—those with deposits in excess of $15 million—thus grew from $560 million in December to $4.3 billion by the end of January—and to $7.3 billion by the end of April.

Despite the intensity of the competition, Western banks held the lion's share of total NOWs—$5.3 billion, or 72.5 percent—at the end of April. S&Ls, by contrast, held only $1.4 billion, or 19.3 percent, and credit unions held the remaining $600 million. Actually, this lopsidedness in market shares is not surprising, since commercial-bank checking accounts to date have provided the primary source of the growth in NOW balances.

Nonetheless, the rate of growth in Western S&L NOW balances has exceeded the rate of growth of bank NOWs and credit-union share drafts. Furthermore, Western S&Ls have outpaced their counterparts in the rest of the country, with a 19-percent as against a 14-percent market share on April 29. This reflects the Western S&Ls extensive branch networks and large-scale operations, which permit them to compete effectively with large Western banks. This is particularly true in California, where many of the nation's largest savings-and-loan associations are headquartered: S&Ls have gained 23 percent of California NOW balances, compared to banks' 69-percent share.

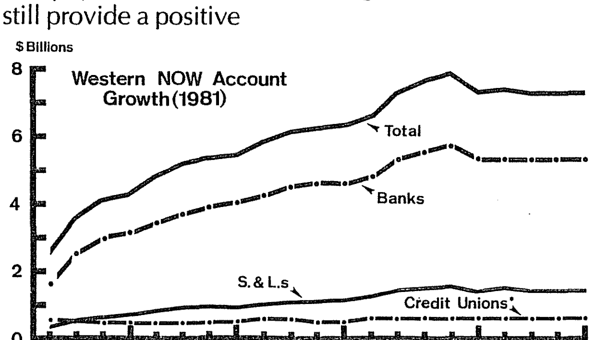
Bottom line

The competition for NOW balances is likely to affect depository institutions' profits significantly. As a group, savings-and-loan associations may end up as beneficiaries of this competition. Nationwide surveys show that the average S&L NOW-account balance approximates $1800—more than enough, according to industry estimates, to cover fixed processing costs, interest payments and required reserves, and still provide a positive spread between current loan rates and the cost of funds. And since 60 to 65 percent of their NOW balances represent "new" funds, S&Ls can use these funds instead of higher-cost alternatives.

The impact of the NOW competition on banks' earnings is more difficult to determine. On the one hand, banks have experienced a substantial increase in interest costs, because 75 to 85 percent of their NOW balances come from their own zero-interest checking balances. On the other hand, banks' efforts to raise charges for checking services (such as stop-payment orders, handling of overdrafts, etc.) may reduce the number of unprofitable accounts they hold, and thus may offset their NOW-related increase in interest costs.

On NOW accounts alone, banks should have no earnings difficulties; since such accounts apparently average close to $6,000, banks can easily maintain a positive spread between their loan rates and the cost of funds. However, the disparity between bank and S&L average NOW-account balances may suggest potential NOW-related earnings problems. In view of the S&Ls' ability to expand their market share and to obtain most of their NOW funds from non-S&L sources, banks may be losing *profitable* accounts to their thrift competitors. If this is true, banks are not likely to sit idle. In fact, many banks already appear to be reevaluating their minimum-balance requirements and their NOW-related packages of services. The competition for NOW deposits has only just begun.

Barbara Bennett



*Credit-union share drafts

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BANKING DATA—TWELFTH FEDERAL RESERVE DISTRICT
(Dollar amounts in millions)

Selected Assets and Liabilities Large Commercial Banks	Amount Outstanding 6/10/81	Change from 6/3/81	Change from year ago Dollar	Change from year ago Percent
Loans (gross, adjusted) and investments*	149,970	879	12,864	9.4
Loans (gross, adjusted) — total#	128,013	855	12,499	10.8
Commercial and industrial	37,571	– 151	3,988	11.9
Real estate	52,511	217	5,683	12.1
Loans to individuals	22,928	22	– 959	– 4.0
Securities loans	1,675	89	682	68.7
U.S. Treasury securities*	6,443	55	46	0.7
Other securities*	15,514	– 31	323	2.1
Demand deposits — total#	41,653	– 199	– 2,067	– 4.7
Demand deposits — adjusted	29,224	650	– 2,271	– 7.2
Savings deposits — total	30,329	17	2,978	10.9
Time deposits — total#	80,331	– 683	15,877	24.6
Individuals, part. & corp.	71,163	– 455	15,712	28.3
(Large negotiable CD's)	31,081	– 715	8,179	35.7

Weekly Averages of Daily Figures	Week ended 6/10/81	Week ended 6/3/81	Comparable year-ago period
Member Bank Reserve Position			
Excess Reserves (+)/Deficiency (–)	n.a.	n.a.	110
Borrowings	173	124	1
Net free reserves (+)/Net borrowed(–)	n.a.	n.a.	109

* Excludes trading account securities.
# Includes items not shown separately.

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