Research Department
Federal Reserve
Bank of
San Francisco

December 5, 1980

FRBSF Weekly Letter

The Time is NOW

On December 31, all commercial banks, savings-and-loan associations and mutual savings banks will be able to offer interest-bearing checking accounts. These accounts, called NOW (Negotiable Order of Withdrawal) accounts, could change the nature of banking in this country and affect the conduct of monetary policy. With the advent of nationwide NOW accounts, commercial banks and credit unions will no longer be the only depository institutions capable of offering interest-bearing checking-type accounts nationwide. Henceforth, S&L's and mutuals will take the opportunity to compete head-to-head with banks as one-stop family financial centers.

Aggressive thrift-institution promotion campaigns will intensify the competition for household accounts. (Regulatory authorities have set the ceiling interest rate on NOW accounts at 5¼ percent, but competition for NOW funds will increasingly center around terms for services.) Many consumers, who until recently have been denied the opportunity to earn explicit interest on their checking accounts, will find NOW accounts very attractive. As a result, NOW balances are likely to grow rapidly.

Rapid growth in NOW balances will heighten the uncertainty affecting the conduct of monetary policy. In February 1981, the Federal Reserve will set the growth-rate ranges for several measures of the money supply for that calendar year. NOW-account growth will affect growth in each of these monetary aggregates differently. Thus, in order to choose appropriate target ranges, the Fed must predict how fast NOW balances will grow and which financial assets will be converted to NOWs. NOW accounts thus will produce benefits for many households, but initially will create difficulties for the Fed in its task of selecting long-run target ranges for money-supply growth.

Birth of NOWs
NOW accounts made their debut in June 1972 when Consumers Savings, a Massachusetts mutual-savings bank, began allowing withdrawals from savings accounts by a check-like negotiable order of withdrawal. By early fall, other mutual savings banks in Massachusetts and New Hampshire had followed Consumers' lead. Effective January 1974, Congress authorized all banks and thrift institutions in Massachusetts and New Hampshire to offer NOW accounts. Then, in 1976, Congress further broadened NOW authority to include depository institutions in Connecticut, Maine, Rhode Island and Vermont. NOW accounts proved to be extremely popular in these six states, growing to a level of $2 billion by December 1976 (see chart). New York and New Jersey institutions began to offer NOWs in 1978 and 1980, respectively.

After several efforts to legalize NOW accounts nationwide, Congress finally granted NOW authority (or similar authority) to all depository institutions with the enactment of the Depository Institutions Deregulation and Monetary Control Act in March, 1980. The ceiling interest rate for NOWs, which will be available to individuals, households and nonprofit organizations, was set at 5¼ percent for all institutions. This is the same figure as the passbook-savings rate at commercial banks and 1/4 percent less than the passbook rate at thrift institutions.

Stiff competition
Although depository institutions cannot accept NOW deposits until the end of the year, competition for NOW dollars is already beginning to heat up. A sizable number of banks and savings-and-loan associations, particularly in the West, have begun to promote NOWs aggressively. Some S&Ls are trying to build a NOW customer base by offering preauthorized-transfer and telephone bill-paying accounts that will auto-

Research Department
Federal Reserve
Bank of
San Francisco

matically be converted to NOW accounts on January 1. But some banks, in their marketing efforts, are trying to get a headstart on the thrift competition by stressing the similarity of their currently-available ATS (Automatic Transfer from Savings) accounts to NOW accounts.

The growing intensity of the competition among depository institutions is most evident in the pricing field, with a wide range of minimum balances and service charges quoted. Minimum balances necessary to avoid service charges on NOW accounts range from zero in a few cases to $2,000 or more. Some institutions do not require minimum NOW balances, but require substantial balances in other accounts. For the NOW account balances or other qualifying account balances that fall below the required minimum, monthly maintenance charges range from $2 to $7, while transactions fees range from zero to 15 cents per check.

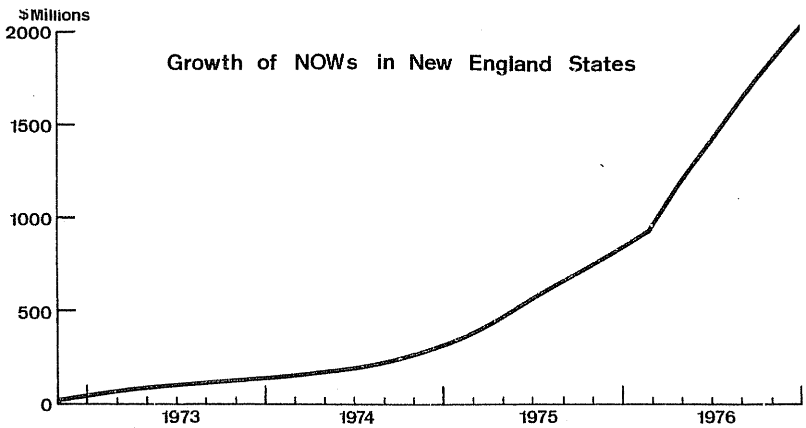
Terms thus vary widely, but as a group, savings-and-loan associations are pricing their NOW accounts more liberally than commercial banks. Many of the major California banks, for example, have announced that the minimum NOW balance necessary to avoid service charges will be $1,500 to $2,000, while some of the larger California S&Ls will require only $500 to $1,000. The reason for this disparity in terms is a difference in the way the different institutions view NOW accounts. Many banks do not view NOWs as a means of expanding their deposit bases, but as a means of protecting their present deposits. After all, bankers are not eager to see all of their regular zero-interest demand-deposit accounts switch to NOWs. By offering a wide variety of services in addition to NOW accounts (such as conveniently-located branch offices, automated-teller machines, etc.), banks may be able to retain a high proportion of their deposits in spite of less liberal terms. Since banks will incur higher costs by offering these services with their NOWs, many are prepared to let their less profitable, lower-balance accounts switch to S&Ls.

Savings-and-loan associations, on the other hand, are generally eager to see their NOW balances grow, because they view NOW accounts as a means of increasing their market share relative to banks. Some S&L executives reason that NOW funds are more likely to come from bank demand-deposit accounts than from their own passbook-savings accounts. They are attracted to this new source of funds, in spite of processing costs and reserve requirements, because it is less expensive than borrowing from Federal Home Loan Banks or paying 12 to 14 percent for funds in the money and capital markets.

The most important reason for S&L pricing behavior, however, may be their recognition of the opportunities available from competing head-to-head with banks for household funds. The ability to offer checking accounts, S&Ls contend, is the key to their ability to retain their share of passbook savings, since the convenience of one-stop banking is a key factor in household decisions about where to put their funds. Despite their ability to offer ¼-percent more than banks on savings-deposit interest, the thrifts' share of passbook savings has declined steadily from 65 percent in 1966 to 53 percent in September 1980, although their share of small time deposits has moved in the opposite direction. Thus, because of a desire to acquire new funds and regain their share of savings funds, savings-and-loan associations are pricing their NOW accounts lower than banks' NOW accounts. This pricing strategy means that S&Ls are likely to gain a large number of accounts, but that the average balance in those accounts may well be lower than in bank-held NOWs.

Pricing strategies

Bankers are concerned that S&Ls and mutuals are adopting an overly aggressive price strategy, either because the thrifts lack experience in pricing checking-type accounts, or because the thrifts are deliberately sacrificing short-run profits to gain market share. (Of course, underpricing makes sense from the thrifts' perspective only if the deposits they lure away from banks do not switch back



once prices are raised to cover costs.) If these institutions are underpricing their NOW accounts, banks may be forced to do the same, so that aggregate financial-institution profits will decline.

The evidence from the New England experience is somewhat mixed. By 1976, most savings banks in Massachusetts and New Hampshire offered free NOW accounts paying the maximum (5 percent) interest rate. Commercial banks, on the other hand, offered NOWs paying 5 percent but required a minimum balance to avoid service charges. Despite the desire to catch up with the savings banks, commercial banks generally did not succumb to the pressure to offer free NOWs. Somewhat surprisingly, then, commercial banks' share of NOW balances in Massachusetts and New Hampshire grew throughout this period, reaching 57 percent by December 1976.

Despite this more conservative pricing strategy, NOW accounts may have been more harmful to New England commercial banks' profitability, both in the short run and over the longer run, than to mutual-savings banks' profitability. Commercial banks in Massachusetts and New Hampshire were generally much more profitable than their thrift competitors before the introduction of NOW accounts, and NOW accounts thus may have served to narrow the gap. This result is consistent with the thrifts' argument that the ability to offer checking accounts makes it possible for them to compete much more effectively with commercial banks.

Monitoring the M's

Aggressive promotion of NOW accounts will cause NOW balances to grow very rapidly in 1981, creating difficulties for the Federal Reserve in its task of setting growth-rate target ranges for the monetary aggregates. The Fed must predict not only how fast NOWs will grow, but whether NOW growth will come primarily at the expense of growth in checking accounts or growth in savings deposits. Shifts from traditional checking acounts to NOWs will cause M-1A, which includes commercial-bank checking accounts, to grow more slowly than in the past. However, shifts from savings and other accounts to NOWs will cause the M-1B aggregate, which includes M-1A and other checkable deposits (primarily ATS and NOW), to grow faster than in the past without changing the rate of growth in M-1A.

The New England experience suggests that roughly two-thirds of NOW balances come from checking accounts, and that the remainder come from other financial assets, primarily savings. NOW growth in 1981 may well repeat this general pattern, since the minimum-balance pricing of NOWs encourages consumers to combine checking and savings funds. Therefore, growth in NOW balances is likely to depress M-1A growth as funds are shifted out of traditional checking accounts, and to boost M-1B growth as funds are shifted out of savings and other interest-earning assets.

In light of the potential for substantial shifts of funds following the introduction of nationwide NOW accounts, there will be less certainty than usual in the expectations of relative growth of the aggregates that the Federal Reserve builds into its money-growth targets. For this reason, the Fed has indicated that caution is necessary in interpreting the initial 1981 targets. As Chairman Volcker said in his monetary-policy report to Congress last July, the Fed will seek reduced rates of monetary growth over the long run, but the range for M-1B, in particular, may have to accommodate a period of abnormal growth as the public adjusts to NOW accounts.

Barbara Bennett

Research Department
Federal Reserve
Bank of
San Francisco
Alaska • Arizona • California • Hawaii
Idaho • Nevada • Oregon • Utah • Washington

FIRST CLASS MAIL
U.S. POSTAGE
PAID
PERMIT NO. 752
San Francisco, Calif.

FIRST CLASS

BANKING DATA—TWELFTH FEDERAL RESERVE DISTRICT

(Dollar amounts in millions)

Selected Assets and Liabilities Large Commercial Banks	Amount Outstanding 11/19/80	Change from 11/12/80	Change from year ago Dollar	Change from year ago Percent
Loans (gross, adjusted) and investments*	143,420	– 706	8,172	6.0
Loans (gross, adjusted) — total#	121,348	– 664	9,083	8.1
Commercial and industrial	35,780	34	3,789	11.8
Real estate	49,477	261	6,882	16.2
Loans to individuals	23,668	– 63	– 292	– 1.2
Securities loans	1,268	85	– 269	– 17.5
U.S. Treasury securities*	6,641	– 46	– 682	– 9.3
Other securities*	15,431	4	– 229	– 1.5
Demand deposits — total#	45,253	–1,878	550	1.2
Demand deposits — adjusted	32,350	–2,871	1,132	3.6
Savings deposits — total	29,339	– 126	392	1.4
Time deposits — total#	67,886	732	9,570	16.4
Individuals, part. & corp.	58,873	648	9,058	18.2
(Large negotiable CD's)	26,462	304	4,538	20.7

Weekly Averages of Daily Figures	Week ended 11/19/80	Week ended 11/12/80	Comparable year-ago period
Member Bank Reserve Position			
Excess Reserves (+)/Deficiency (–)	(n.a.)	(n.a.)	– 9
Borrowings	245	96	187
Net free reserves (+)/Net borrowed(–)	(n.a.)	(n.a.)	– 196

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

Editorial comments may be addressed to the editor (William Burke) or to the author .... Free copies of this and other Federal Reserve publications can be obtained by calling or writing the Public Information Section, Federal Reserve Bank of San Francisco, P.O. Box 7702, San Francisco 94120. Phone (415) 544-2184.