

Economic Commentary

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The Battle for NOWs

by Paul R. Watro

Competition among depository institutions has intensified since January 1, 1981, when commercial banks, savings and loan associations, and mutual savings banks were authorized to offer negotiable order of withdrawal (NOW) accounts nationwide. Depository institutions can now compete for interest-bearing transaction accounts of households and nonprofit organizations.¹ The banking industry as a whole conceivably will lose some of its share of the third-party payments (or transaction account) market. Through aggressive marketing efforts and pricing schemes, banks can lessen the competitive impact of NOW accounts; indeed, some banks even may gain an additional share of the transaction account market.

Growth of NOW accounts and the market share of banks and thrifts showed substantial differences in the New England states, where NOW accounts have been available for several years.² Much of the variation in the growth of NOWs has been attributed to pricing and the extent that depository institutions ac-

tually offered NOW accounts. Differences in market share reflected the relative importance of thrift institutions in the state banking structure, the pricing policies of thrifts and banks, and the stringency of minimum-balance requirements at banks and thrifts.

This *Economic Commentary* examines the growth of NOW account balances, along with changes in other transaction balances, at banks and thrifts in the Fourth Federal Reserve District since December 1980.³ NOW account balances of banks and thrift institutions are analyzed in six SMSAs—three in Ohio (Cleveland, Cincinnati, and Toledo) and one each in Pennsylvania (Pittsburgh), West Virginia (Wheeling), and Kentucky (Lexington).

Growth

Growth of NOWs in the Fourth District (4D) has been rapid (see table 1). Fourth District depository institutions accumulated \$3.3 billion in NOW balances as of July 1981, representing almost 15 percent of their total transaction deposits (NOW, demand, auto-

1. Banks and savings and loan associations are permitted to offer NOW accounts to nonprofit organizations that are granted tax exemptions by the Internal Revenue Service and to public institutions, such as state universities or city hospitals.

2. See Ralph C. Kimball, "Variations in the New England NOW Account Experiment," *New England Economic Review*, Federal Reserve Bank of Boston, November/December 1980, pp. 23-39.

3. The term *thrifts* includes savings and loan associations and mutual savings banks. Credit unions are excluded because they offer share drafts rather than NOW accounts.

The Fourth Federal Reserve District includes all of Ohio, the eastern part of Kentucky, the western part of Pennsylvania, and a small portion of West Virginia. Pennsylvania is the only state in the Fourth District where mutual savings banks operate.

market share can be attributed to many factors, including the relative importance of thrift institutions in the SMSA market, price differences of NOWs between banks and thrifts, price differences of checking and NOW accounts at banks, and non-price differences among institutions, such as marketing efforts and auxiliary services.⁸

The presence of thrifts in the market had some influence on the success of generating NOW accounts. The percentage of offices and total deposits held by thrifts was used to measure their importance in the selected SMSAs. These measures generally were inversely related to the success of banks in the battle for NOWs, although a one-to-one relationship did not occur. Banks gained the largest percentage of NOW balances in Lexington, where thrifts had the smallest percentage of offices and deposits.

A second factor affecting market share has been the pricing policies of banks and thrift institutions. Both banks and thrifts offer NOW accounts that pay interest of 5.25 percent, with no service charges if a minimum or average balance is maintained. If the balance falls below the stipulated amount, the depositor is assessed a monthly service charge that may include transaction fees. The average prices of the three or four largest banks and thrifts operating in the selected SMSAs form a basis for price comparisons.⁹ Pricing elements can include monthly service charges, per transaction fees, and the minimum balance required to avoid any charges. While prices often vary among institutions, the average pricing terms

8. While it is recognized that these factors may be interdependent, they are treated as independent variables in the analysis.

9. Average prices were calculated from the prices charged by the three or four largest banks and thrifts during the first five months of this year. When the pricing terms of one of the three largest institutions were not comparable, the prices of the fourth largest institution were used.

of the largest banks and thrifts are assumed to reflect the going prices for each type of institution in the given SMSA.

While thrifts typically had lower pricing terms, the price gap between banks and thrifts varied widely among the SMSAs. As expected, thrifts generally gained a larger share of NOWs in those markets where they established the greatest pricing advantages. Among the markets, for example, thrifts were the most successful in Cleveland and Pittsburgh, where they maintained the most attractive pricing terms compared with competing banks. Price differentials were less favorable at thrifts in the other SMSAs. In fact, the Lexington banks had slightly lower service charges than the local savings and loans, but they set low minimum-balance requirements to avoid their charges.

Another important reason for the success of banks in gaining NOW business has been the price of checking accounts relative to NOW accounts. Assuming that individuals perceive NOW accounts as substitutes for checking accounts, their pricing would influence the amounts held by banks. Since checking accounts do not earn interest, individuals have a financial incentive to switch to NOW accounts unless the pricing of these accounts outweighs their interest-earning advantage. Banks operating in SMSAs that maintained the smallest price differences had a tendency to register the greatest gain in their share of NOW balances. Simultaneously, these banks also generally experienced the largest percentage reduction in demand deposits among the market areas.

Non-price factors obviously have had some influence in the battle for NOWs, and this type of competition presumably varied among the six SMSAs. Marketing efforts and auxiliary services, such as overdraft protection and automatic teller machines, would be expected to affect the relative success of banks and thrifts in generating NOW business. While no hard data are available on

marketing efforts, more banks were found to offer these auxiliary services than thrifts. Cincinnati and Cleveland thrift institutions apparently were the most competitive with banks, as the three largest savings and loan associations provide either automatic teller machines or overdraft protection.¹⁰

Summary

Growth of NOW accounts in the 4D has been rapid, as most depository institutions have utilized their recently acquired authority to offer these interest-bearing transaction accounts. Over 75 percent of the NOW balances was generated during January and February of this year, and a large portion of these funds appeared to originate from checking and other types of transaction accounts. Banks have cap-

10. The Cincinnati savings and loan associations, along with other institutions, provide automatic teller machines on a joint basis.

tured 87.5 percent of the NOW balances, despite charging higher prices than thrift institutions. Since January 1981 the bank share of net inflows to NOW balances has declined significantly; because of reduced volumes, the overall bank share fell only by 5.5 percentage points.

The success of banks in gaining NOW balances varied among the SMSAs examined. Much of the bank-market share variation can be attributed to differences in the relative importance of thrift institutions, differences in NOW account pricing between banks and thrifts, pricing disparities between checking and NOW accounts at banks, and the non-price competition among institutions.

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Table 1 NOW Growth and Other Deposit Changes^a

Millions of dollars

Deposit type	1980		1981						December to July change
	December	January	February	March	April	May	June	July	
NOW	1	996	2,152	2,585	3,014	3,013	3,176	3,314	3,313
Demand	20,060	20,953	17,648	17,702	18,221	17,340	17,311	17,730	-2,330
Automatic transfer	1,139	765	588	561	581	561	546	540	-599
Telephone and pre-authorized	819	736	645	686	690	630	615	589	-230
Total transaction	22,019	23,350	21,033	21,506	22,506	21,544	21,648	22,173	154
Savings	26,350	26,245	24,448	24,717	24,717	24,256	23,846	23,697	-2,643
Time	63,570	66,046	67,084	67,721	67,721	68,270	29,825	69,443	5,873

a. Deposits include those of banks, savings and loan associations, and mutual savings banks in the Fourth District. Figures are weekly averages based on daily figures for the first full reporting week (Thursday to Wednesday) in each month. Figures are slightly understated, because smaller institutions do not report on a daily basis.

SOURCE: Report of Transaction Accounts, Other Deposits, and Vault Cash, Federal Reserve System.

matic transfer, and telephone and pre-authorized accounts).⁴ Such rapid growth can be attributed to the widespread offering of NOW accounts by most banks and savings and loan associations and their aggressive marketing efforts. Over 75 percent of the NOW account growth occurred during January and February of this year. While NOW balances are still increasing, the pace has slowed substantially since the beginning of the year. In fact, NOW account balances failed to grow between April and May at 4D institutions.

Despite the large buildup of NOW account balances, total transaction balances at 4D depository institutions registered only a \$154-million net increase. Apparently many depositors switched funds from other accounts to open NOW accounts. The depository institutions experienced declines in demand deposits (\$2,330 million), auto-

4. Figures represent weekly averages based on daily figures for the first full reporting week (Thursday to Wednesday) in each month. These data are derived from the reserve-accounting report submitted to the Federal Reserve Bank of Cleveland. Figures are slightly understated, because smaller institutions do not report on a daily basis and all credit unions are excluded.

matic transfer savings (\$599 million), and telephone and pre-authorized transfers (\$230 million). These institutions also reported a \$2,653-million net outflow of savings deposits since December 1980. While some of the savings deposits were transferred to NOW accounts, a large portion of these funds probably were shifted to higher-yielding certificates of deposit and money-market funds.⁵

Market Share

Banks had a natural advantage in introducing NOW accounts because of their near monopoly of the checking account market. In fact, some banks automatically converted eligible checking accounts into NOW accounts. Attempting to compete against this advantage, thrift institutions generally began offering NOWs at lower charges and balance requirements than banks. While such pricing encourages lower-balance depositors to open NOW accounts at thrift institutions, it would seem unlikely to in-

5. Time deposits increased by \$5.9 billion at 4D banks and thrift institutions, and money-market funds rose from \$76.6 billion to \$129.7 billion between December 1980 and July 1981.

Table 2 NOW and Transaction Balances and Market Share^a

	1980		1981					
	December	January	February	March	April	May	June	July
NOW balances, \$ mil								
Banks	1	926	1,956	2,326	2,688	2,676	2,802	2,900
Thrifts	0	70	196	259	326	337	374	414
Market share, percent ^b								
Banks	100	93.0	90.9	90.0	89.2	88.8	88.2	87.5
Thrifts	0	7.0	9.1	10.0	10.8	11.2	11.8	12.5
Total transaction balances, \$ mil								
Banks	21,654	22,955	20,567	20,984	21,876	20,915	20,989	21,487
Thrifts	365	395	486	550	630	629	659	686
Market share, percent ^b								
Banks	98.3	98.3	97.8	97.4	97.2	97.1	97.0	96.9
Thrifts	1.7	1.7	2.2	2.6	2.8	2.9	3.0	3.1

a. Figures are weekly averages based on daily figures for the first full reporting week (Thursday to Wednesday) in each month. Thrifts include savings and loan associations and mutual savings banks. Total transaction balances include demand deposits, automatic transfer savings, telephone and pre-authorized transfers, and NOW deposits. Figures are slightly understated, because smaller institutions do not report on a daily basis.

b. Market share balances of NOW accounts are estimates based on the proportion of total deposits at offices within the SMSA.

SOURCE: Report of Transaction Accounts, Other Deposits, and Vault Cash, Federal Reserve System.

duce higher-balance customers to switch to another institution if they already were receiving no-charge NOW accounts at a bank.⁶

In view of these factors, it is not surprising that banks have competed effectively for NOW balances (see table 2). By February 1981, banks gained 91 percent of NOW balances in the 4D. A large portion of these funds probably originated from deposits that were switched from other accounts. Other types of bank deposits—demand, automatic transfer, telephone and pre-authorized, and savings—declined over this two-month period.

Since January 1981, however, thrift institutions have consistently gained an increasingly larger share of the net inflows of NOW accounts. After gaining only 7 percent in January, thrifts increased their share of

6. Lower service charges might make it profitable for high-balance depositors to change institutions, particularly if they prefer to economize on their transaction balances.

monthly inflows of NOW balances, reaching a high of 29 percent in July. Although the volume of NOW growth has decreased greatly, thrifts have improved their overall share of NOW balances outstanding by 5.5 percentage points since January, reaching 12.5 percent in July.

Because of the growth in NOW accounts, thrifts increased their share of total transaction balances from 1.7 percent in December 1980 to 3.1 percent in July 1981. This was accomplished by a \$414-million increase in NOW balances, offset by a \$93-million decline in other transaction balances, for a net gain of \$321 million. In contrast, banks experienced a net reduction of \$167 million in transaction balances.

Market Area

Another way to gauge the relative success of banks and thrifts in attracting NOW accounts is to examine competition in individual market areas. Indeed, the geo-

Table 3 Market Share and Thrift Competition in Selected SMSAs

	Cincinnati	Cleveland	Lexington	Pittsburgh ^a	Toledo	Wheeling
	Market share of NOW balances (May 1981), % ^b					
Banks	87.2	79.3	99.0	86.7	94.3	93.1
Thrifts	12.8	20.6	1.0	13.3	5.7	6.9
Offices operated by thrifts, %	46.9	38.3	16.0	35.0	25.7	20.0
Deposits held by thrifts, %	48.1	43.6	16.2	28.6	38.9	27.7
Minimum balance to avoid fees, \$ ^c						
Banks	1,000	1,417	933	1,833	833	667
Thrifts	383	350	500	500	508	567
Difference	617	1,067	433	1,333	325	100
Monthly service charge, \$ ^c						
Banks	5.53	7.35	4.33	4.67	3.83	4.67
Thrifts	4.67	4.42	4.50	3.33	3.75	4.17
Difference	0.86	2.93	-0.17	1.34	0.08	0.50
Average price difference between NOW and checking accounts						
Minimum balance to avoid fees, \$	367	950	633	1,000	400	400
Monthly service charge, \$	1.78	2.77	1.83	2.84	1.66	2.67
Reduction in demand deposits (December to May), %	15	13	18	10	20	18

a. Although all of the largest depository institutions in the selected SMSAs offered NOW accounts, two of the Pittsburgh banks did not offer them to individuals. These banks, however, continued to provide automatic transfer savings accounts for individuals over the period examined.

b. Market-share balances of NOW accounts are estimates based on the proportion of total deposits at offices within the SMSA.

c. Prices are averages calculated from prices charged by the three or four largest banks in each of the SMSAs during the first five months of 1981. Minimum-balance requirements refer to those maintained in NOW accounts only; in Pittsburgh, however, savings and NOW balances are collectively applied to the requirement. All NOW and checking accounts refer to the least-cost minimum-balance type, assuming monthly transaction of three deposits and fifteen checks. An average service charge is used for institutions offering sliding-scale charges.

SOURCES: Report of Transaction Accounts, Other Deposits, and Vault Cash, Federal Reserve System; Summary of Deposit Data, Federal Deposit Insurance Corporation; and an informal telephone survey.

graphical area in which depository institutions compete varies according to the type of product or service provided. Institutions compete for large construction loans in regional and national markets, whereas competition for such services as individual savings, checking, and NOW accounts generally is confined to smaller regional or local areas.

NOW account balances of banks and thrifts were analyzed in six of the largest standard metropolitan statistical areas

(SMSAs) in the 4D. NOW balances captured by banks differed widely among these SMSAs. After five months, the bank-market share of NOWs varied between 79.3 percent in Cleveland to 99.0 percent in Lexington (see table 3).⁷ These variations in the bank-

7. The share of NOWs held by banks and thrift institutions is estimated, because data are reported by institution rather than by office. Several large institutions operate offices in more than one SMSA. Estimates are based on the proportion of total deposits held by offices within a given SMSA.