MONEY MARKET CERTIFICATES: AN INNOVATION IN CONSUMER DEPOSITS

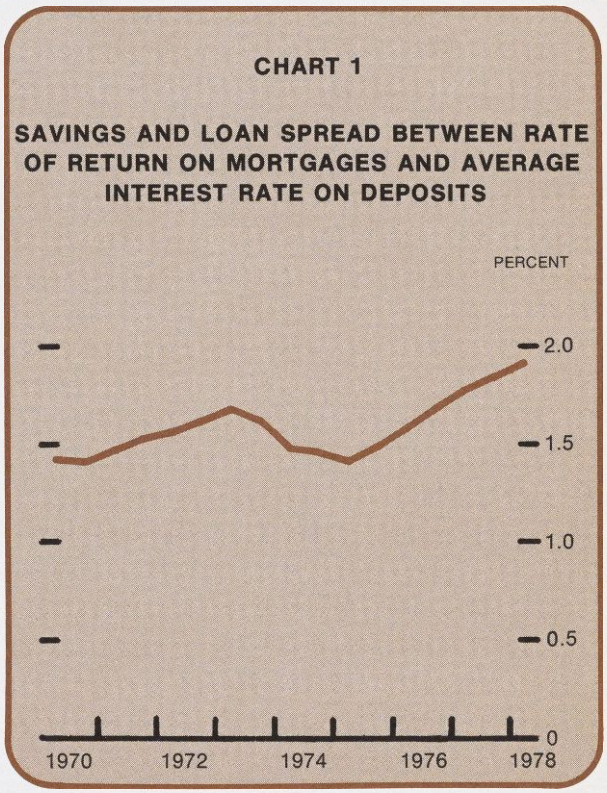
by John M. Godfrey and B. Frank King

In May 1978, Federal regulators of savings and loan associations, mutual savings banks, and commercial banks first allowed these institutions to offer two new types of time certificates of deposit. One had a minimum maturity of eight years and a fixed maximum offering rate. Except for its longer maturity, it resembled other time certificate types. The other new time certificate was a departure from previous time deposit regulation. Its maximum offering rate changed weekly with money market interest rates. It quickly became known as the "money market certificate." This innovation may well be a model for future evolution of regulation of time and savings deposits. An analysis of its background and development should help our understanding of the forces driving this evolution.

WHY A MONEY MARKET CERTIFICATE?

The regulators' money market certificate innovation came in a set of circumstances that was all too familiar to them and to the institutions that they regulate. Interest rates had been rising for more than a year and had reached levels that had begun to cause weakness in deposit inflows, particularly at savings and loan associations and mutual savings banks—the nonbank thrift institutions. More interest rate increases looming on the horizon threatened to begin a period of disintermediation similar to those that plagued financial intermediaries in 1966, 1969-70, and 1973-74. Concern for the thrifts' problems was accompanied by worries about the maintenance of housing production. These were magnified by a low rate of housing starts in the first quarter of 1978 and the widespread belief among housing analysts that starts would be lower in 1978 than they had been in 1977.

Against this background, the regulators sought ways to allow "financial institutions to compete for funds to assure an adequate flow of credit into housing and to meet other borrowing needs."[1] They were aided in their choice of methods by the cushion of earnings that the thrift institutions had developed during the preceding period of low short-term interest rates and relatively high mortgage rates. For example, savings and loan associations' average returns on mortgages minus their average yield on deposits had risen from 1.43 percentage points during the first half of 1975 to 1.93 during the first half of 1978 (see Chart 1). That net return was .33 percentage points above their average for the 1970s.



[1] Board of Governors of the Federal Reserve System, press release, May 11, 1978, p. 1.

The regulators reacted to their concerns and the thrifts' good fortune with an innovative time certificate. It had a term of six months, with a substantial penalty for early withdrawal; its minimum denomination was $10,000; it was not negotiable; and, most importantly, its contract rate was tied to the auction rate on the six-month U.S. Treasury bills (thrifts were allowed to pay one quarter of a percentage point more than the six-month bill rate; commercial banks were allowed to go only as high as the bill rate).

These money market certificates (MMCs), with their $10,000 minimum, were designed to retain those deposits that financial institutions were most likely to lose during periods of high interest rates. The new powers allowed the institutions to adjust the interest rates they paid for these deposits to those on competing savings instruments without raising the interest cost of all savings deposits.

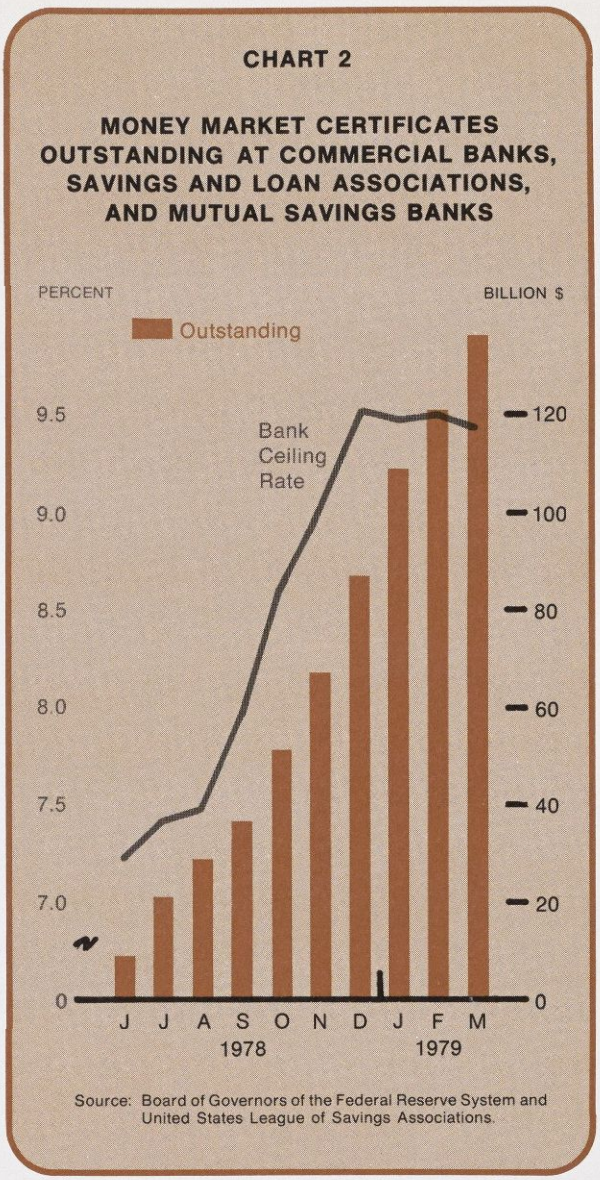
HOW WELL DID THE INNOVATION WORK?

As a marketing venture, money market certificates were quite successful. Most institutions began to issue them soon after they were allowed to. Most chose to pay the maximum permissible rate. As short-term rates increased until early in 1979, the volume of MMCs outstanding rose. By the end of March 1979, it had reached $136 billion, a volume equal to more than twice the year-end 1978 assets of all credit unions in the U. S. (see Chart 2).

Nonbank Thrift Institutions. Because they are considerably more likely to suffer disintermediation than are commercial banks, the nonbank thrift institutions had more at stake in the MMCs. They used their new powers aggressively, taking on $95 billion in MMCs—70 percent of the total outstanding—by the end of March. MMCs made up more than 16 percent of their deposit liabilities at that time.

Thrifts' use of money market certificates did considerably more than avoid the type of disintermediation that had been experienced during other periods of high nominal interest rates.[2] Outflows from accounts other than MMCs between June 1978 and March 1979 were about $48 billion—one-half of MMC inflows. In only three months during that ten-month period were there net inflows to other categories of deposits, but the thrift institutions did not suffer net outflows in any month.

On the asset side of the balance sheet, the nonbank thrift institutions suffered much less than they had during other periods of high interest rates. Although mortgage lending was off in late 1978 and early 1979, it declined much less sharply than it



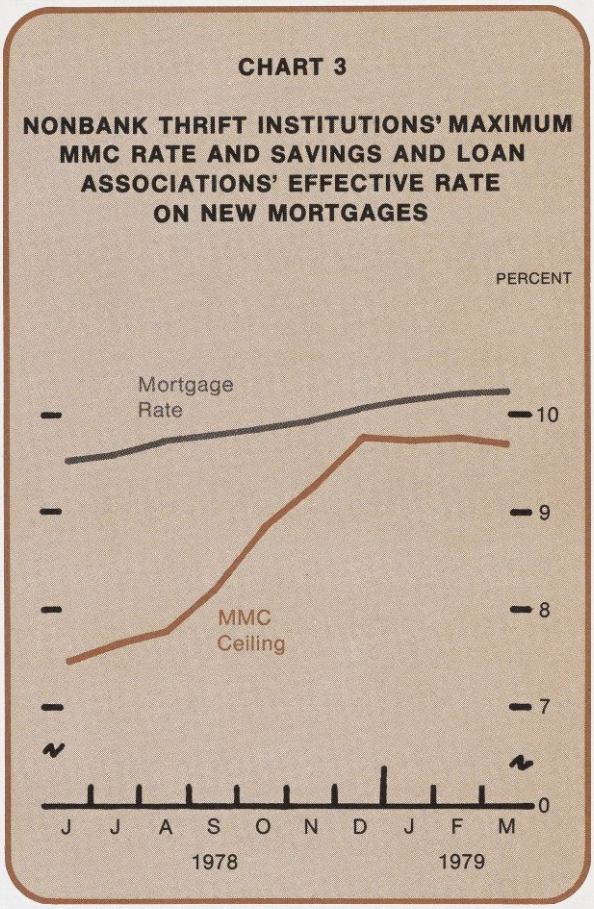
[2] For a cogent analysis of deposit behavior at thrift institutions during the last half of 1978 and other high interest rate periods, see R. Alton Gilbert and Jean M. Lovati, "Disintermediation: An Old Disorder with a New Remedy," **Review,** Federal Reserve Bank of St. Louis, Vol. 61, January 1979, pp. 11-14.

had in previous periods of high interest rates. Whether this lending actually added strength to housing demand or merely displaced mortgages that would have been made through other channels is debated. The article at the beginning of this issue of this **Review** argues that MMCs probably contributed little to housing demand.

The rousing popularity of MMCs brought problems along with it. These showed up most clearly and painfully in nonbank thrift institutions' net interest margins. MMC ceilings rose much faster than mortgage rates after June 1978, cutting the spread between the cost of this source of new funds and the return on new mortgages from a little more than 2 percentage points to less than one-half of one percentage point by early 1979 (see Chart 3). This reduction of the net return on new thrift assets decreased their average margins. Rising MMC inflows late in the year and the need to roll over maturing MMCs at higher rates after November magnified the squeeze.

The amount of this squeeze is difficult to document with precision. A minimum estimate of its effect is a reduction of the average net return by at least a quarter of a percentage point, which ate up most of the cushion that the nonbank thrifts had in June 1978. Certainly, evidence of the squeeze can be seen in the narrowing rate spread, the complaints of the thrift institutions, their trade associations and their regulators, and the proposals of these groups for liberalizing terms and rates on other, less costly time certificates. According to the regulators' statement, this squeeze on thrifts was also a key consideration in the March decision to forbid interest compounding on MMCs and to eliminate the quarter point interest rate advantage for the thrifts when the Treasury bill rate exceeds 9 percent.[3]

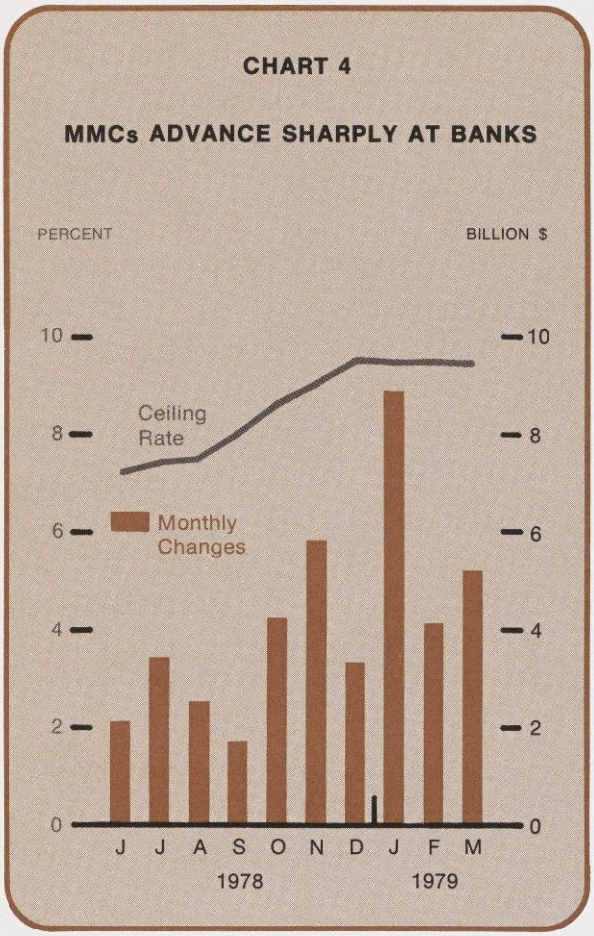
In sum, the nonbank thrift institutions chose to issue a large volume of money market certificates to an enthusiastic public. Their choice avoided almost certain disintermediation and allowed them to continue to add mortgages to their portfolios at a pace that was faster than usual in high interest periods. Issuing the certificates in large volume also put a cost



squeeze on these institutions and, in March, resulted in a modest retreat from the original conditions but, significantly, not from the tie to Treasury bills.

Commercial Banks. But thrift institutions were not alone in offering MMCs. Commercial banks also have availed themselves of the opportunity provided by the Regulation Q amendments. Their experience with money market certificates has been similar to that of the nonbank thrift institutions (see Chart 4). Commercial banks began issuing MMCs in June 1978 and, by March of this year, had $41.2 billion in MMCs outstanding. MMCs now comprise about 8 percent of banks' consumer time and savings deposits. Most of the growth in MMCs, however, came after September, when the ceiling rate moved up above 8 percent. Banks have issued over three-quarters of their total volume of MMCs outstanding since September. The availability of 8-percent

[3] Board of Governors of the Federal Reserve System, press release, March 8, 1979, p. 2.



MMCs EXPAND BANK DEPOSITS

(billion $)

	May 1978	Feb. 1979	Change
Total Time and Savings Deposits	572	619	+47
Passbook Savings	223	216	- 7
Time Deposits under $100,000			
MMCs	0	41	+41
Other	169	152	-17
Time Deposits over $100,000	180	210	+30

interest rates seemed to be a "magic" number that attracted a large amount of consumer deposits. (Eight percent is the highest rate that banks can pay on their longer maturity consumer time deposits.)

The heavy volume of MMCs has precipitated a significant change in the structure of bank time and savings deposits (see table). Between May 1978, immediately before the introduction of MMCs, and March 1979, total bank time and savings deposits advanced $47.5 billion. During this time, however, there were significant changes in several deposit categories. Passbook savings deposits declined $6.5 billion, and small-denomination time deposits, excluding MMCs, fell $17.4 billion. At the same time, large-denomination time deposits rose $30.1 billion.

To what extent did consumers shift funds out of bank passbook savings and other small-denomination time deposits into bank MMCs and, therefore, cause the weakness in the other deposit categories? To what extent did banks' ability to offer MMCs allow them to attract additional deposits? There are several reasons to believe that not all of the declines in other bank consumer deposits were necessarily associated with shifts of funds into bank MMCs. However, even if the entire decline in passbook savings and other small-denomination time deposits were attributable to MMCs, the MMCs would have resulted in net deposit gains for banks of about 40 percent.

However, passbook savings on a seasonally adjusted basis continued to advance through September 1978 while the volume of MMCs outstanding at banks reached nearly $10 billion. Therefore, during the first four months that MMCs were offered, they did not appear to have resulted in any net outflows from passbook savings. Since then, the decline in savings accounts and other small-denomination time deposits undoubtedly has reflected the movement of some funds into bank MMCs. However, at least part of the deposit loss at banks stemmed from shifts of funds into MMCs at nonbank thrift institutions and other financial instruments. It seems reasonable to conclude that 50 percent or more of the funds in MMCs represented a net gain in deposits for commercial banks.

To the extent that banks were able to attract additional funds through MMCs, they did not have to rely as heavily on more expensive large-denomination CDs and other forms of managed liabilities. Thus, MMCs

helped stabilize bank deposit flows and provide a means of retaining the funds of many existing customers. The banks' ability to serve existing depositors in the face of strong competition from nonbank financial institutions is an important consideration in their ability to maintain customer relationships.

The benefits of MMCs to banks and thrift institutions have been greater than just the net gain in deposits. MMCs very clearly prevented considerable disintermediation from taking place as interest rates rose above Regulation Q ceilings. The types of funds that MMCs attracted—deposits of $10,000 and over—are the very ones that would have most likely left these financial institutions as market interest rates approached current levels. To persons with $10,000 to invest, there are several instruments available which carry higher rates of interest than banks and thrifts could pay on short (and even the longer) maturity deposits before MMCs were authorized. For example, Treasury bills can be purchased in denominations of $10,000; and Treasury notes and bonds, in denominations as low as $5,000 and $1,000, respectively. Also, a number of money market mutual funds are available with initial deposits as low as $1,000 or $2,000. Even commercial paper is offered in amounts slightly above the MMC minimum. Clearly, the majority of funds currently in MMCs would not have remained in the financial institutions, given recent levels of interest rates, if banks and thrifts had not been able to offer money market certificates. Nor would these institutions have been able to attract additional funds. By these measures, the MMCs have been highly successful for banks and thrifts.

FURTHER INNOVATIONS?

With interest rates of 9 to 10 percent on money market certificates receiving wide publicity, consumer groups, and especially retired persons, have been quite vocal in asking Federal regulators to increase their interest-bearing deposit options. In particular, there has been pressure to obtain (1) higher interest rates, (2) deposits with lower minimum denominations, and (3) deposits of greater liquidity, i.e., reduced penalties for early withdrawals. While banks and nonbank thrifts are authorized to pay as much as 8 percent on certain long-term deposits, these deposits carry substantial interest penalties if they are redeemed prior to maturity. What consumers want are deposits with higher interest rates without excessive withdrawal penalties in affordable denominations.

The Federal financial regulatory agencies must conform to congressional intent and law in framing deposit interest rate controls. These regulators recognize that congressional "objectives protecting the thrift industry and sustaining mortgage credit plans appear to have overshadowed the desire to provide small savers with a market-oriented rate of return."[4] As pointed out above, thrifts cannot afford to offer interest rates that approach current short-term market rates on a substantial portion of their deposits because their earning assets are primarily in long-term, fixed-rate mortgages. Therefore, the perceived viability of the thrift industry, not commercial bank earnings that can adjust more quickly to fluctuations in market rates, is of prime importance in regulators' consideration of liberalization of interest rate ceilings.

To these ends, the Federal bank and thrift regulatory agencies have made four proposals that would meet the objectives of consumers and ensure that thrifts will not experience severe earnings pressures.[5] The first two proposals involve entirely new types of time deposits, and the other two would change the restrictions on existing deposits. All these proposals would apply to both banks and thrift institutions except credit unions. Nothing in the proposals would require the banks and thrifts to offer all of these options, even if they are approved. An institution's own judgment and competitive conditions would determine whether or not they would actually be offered.

One new deposit would be a "rising-rate certificate" that would pay an increasingly higher rate of return the longer it is held. For example, during the first year, banks could pay a 6-percent rate of return; by the fifth through eighth years, they could

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[4] J. Charles Partee, statement before the Subcommittee on Financial Institutions of the Committee on Banking, Housing and Urban Affairs, United States Senate, April 11, 1979.

[5] Board of Governors of the Federal Reserve System, press release, April 3, 1979.

pay as much as 8 percent. Compounding of interest would be allowed, so that over the eight-year period, the simple rate of return would average about 7¼ percent. The thrift industry would retain its traditional and one-quarter of a point rate advantage, a differential that is legally mandated for types of deposits in existence in 1975. The withdrawal penalties of this deposit would go a long way toward meeting demands for greater liquidity: Three months' interest would be foregone if the deposit were redeemed during the first year, but any redemptions after one year would not carry any interest penalty at all.

The other proposed new deposit would be a "five-year certificate" on which the contract rate would be tied to the preceding month's average yield on five-year Treasury securities (the rate paid would *not* change during the five-year period, however). Commercial banks could pay a maximum of 125 basis points less than that average, and thrifts, a maximum of 100 basis points less. If this deposit had been available in April, its rate of return would have been linked to the average five-year Treasury note rate in March, which was 9.2 percent; banks could thus have paid 7.95 percent. This deposit has the advantage, of course, that its contract rate would vary with a market-determined rate. It would also offer considerable liquidity; the penalty for premature withdrawal would be the loss of six months' interest.

The regulatory agencies have also proposed two changes to existing accounts. One would be a "bonus savings account" on which financial institutions could pay an extra ½ percent on the minimum balance held in a passbook savings account for the preceding 12 months. Another proposal would lower the minimum denomination on longer maturity time certificates. Nonbank thrift institutions currently have a $1,000 minimum denomination on all time certificates; banks have a $1,000 minimum on all certificates maturing in four years or more. The proposal would lower the minimum denomination to $500, which would apply only to those certificates maturing in four years or over. The proposed changes to existing deposits will not likely attract a great deal of additional funds for financial institutions, but they will allow the small depositor to receive higher interest rates and to purchase some of the longer maturity certificates. The combination of proposals represents an attempt to formulate an acceptable compromise of diverse interests in the matter of the payment of higher interest on consumer deposits. The proposals were offered for public comment in order to obtain the views of these interests.

Regulatory Changes. In late May, Federal bank and thrift regulatory agencies jointly adopted four measures to become effective July 1 that incorporated many of the above proposals.[6] The maximum rate on passbook savings accounts was increased ¼ of 1 percent (to 5¼ percent at banks and 5½ percent at nonbank thrifts). Both banks and thrifts will be allowed to offer a four-year savings certificate, with the ceiling rate based on the yield on four-year maturity Treasury securities. (Banks may pay 125 basis points less and thrift institutions, 100 basis points less.) These changes will allow savers higher rates of return, and the new certificate will provide returns more in line with comparable market interest rates.

To permit small savers to purchase these deposits, all legal minimum denominations on consumer time deposits will be eliminated (except for the $10,000 required for MMCs). Financial institutions, however, may still establish their own minimum denominations. To provide greater liquidity, required early withdrawal penalties will be eased for deposits issued or renewed after July 1. For deposits maturing in more than one year, the minimum penalty will be the loss of six months' interest, while for those deposits maturing in one year or less, the penalty will be three months' interest.

These changes in Regulation Q are a small step toward offering consumers higher interest rates, increased liquidity, and, through lower minimum denominations, an enhanced ability to purchase the deposits. The regulatory agencies plan to consult again later this year to determine whether further adjustments in deposit interest rate ceilings are appropriate. ■

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[6]Board of Governors of the Federal Reserve System, press release, May 30, 1979.