

NEWS RELEASE



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INTEREST RATE REGULATION

An Address

By

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Washington, D. C.

Before the

STATE BANK DIVISION, AMERICAN BANKERS ASSOCIATION

in the

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INTEREST RATE REGULATION

I would like to discuss with you today one aspect of bank supervisory powers that has attracted quite a great deal of attention recently -- the power to set maximum interest rates payable on time deposits. The subject may seem mundane and primarily of concern to bank regulatory agencies. It is a subject, however, that has broad ramifications for banking as a whole because of its impact on the competitive position of individual banks or groups of banks vis-a-vis each other or in relation to other financial institutions. It is important also because it affects the earnings and profitability of banks, and the structure of bank assets and liabilities -- and thus the over-all strength of the banking system. I am not planning to discuss today the separate question whether regulations governing interest rate ceilings should be retained or abolished. Rather, my principal concern will be with the role that interest rates and interest rate regulations have played in recent years in allocating funds among various financial institutions.

Interest rates paid by banks for funds have become increasingly important over the past decade for both international and domestic reasons. Since 1958, the United States has had to take much more explicit recognition of international considerations in the formulation of monetary and fiscal policy -- because of the role of the dollar as the leading international currency, the persistence of deficits in our balance of payments accounts,

and the simultaneous and steady dismantling of controls abroad over international trade and payments. The increased mobility of short-term funds across national boundaries in response to interest rate differentials has added a new dimension to the situation. These movements of interest-sensitive money were at times disruptive both of foreign exchange markets and national economies.

Within our borders, interest rate consideration also became more important to commercial banks seeking to maintain their share of the credit markets. The upsurge in the demand for credit to finance higher levels of consumer and business spending in the late 1950's exhausted the previously ample lending capacity of banks. Restrictions on maximum rates of interest payable on loanable funds -- that hitherto had caused little discomfort -- soon placed commercial banks at a decided disadvantage in competing with other financial institutions for the limited supply of savings. Banks found themselves having to compete for funds both at home and abroad on the basis of price -- or interest rates -- as well as on the basis of nonprice considerations -- such as marketability. All banks in this country faced competition from other financial intermediaries or money market instruments created outside the banking system; while the larger banks also encountered strong competition from the existence of alternative investment opportunities abroad. Under these circumstances, the ceilings on interest rates payable on time deposits were raised by the Federal Reserve and the Federal Deposit Insurance Corporation on January 1, 1957 for the first time since their inception 21 years earlier.

The subsequent greatly expanded inflow of funds into banks and the greater variety of asset choice that became available presented new and

challenging problems to banks. As an industry, they have met this challenge successfully and imaginatively. They have been able to satisfy, more effectively and efficiently, the short- and medium-term financing needs of the expanding economy.

Some problems have arisen, nonetheless, as will always be the case in an economy and banking system as dynamic and ever-changing as ours. A little later I would like to outline a proposal that should help to meet one of the problems that has appeared among a small number of banks. First, I would like to sketch briefly the background of interest rate regulations.

Federal statutory controls over interest rates payable on time and savings deposits were first instituted in the Banking Acts of 1933 and 1935. These controls were part of the basic banking reform legislation designed to protect the banking system against recurrence of pressures such as those that developed during the Great Depression. Many factors combined to precipitate the economic collapse of the early 1930's -- only one of which was unhealthy competition for funds and their subsequent placement in speculative and unsound investments. The inclusion of regulatory ceilings on interest rates payable on time and savings deposits was motivated partly by Congress' expressed desire to curb/excessive and uneconomic competition among banks. At the same time an upper limit to interest rate payments was felt to be a contribution to holding down costs and enhancing needed bank profitability.

The maximum interest rates originally established on January 1, 1936, ranged from 1 percent on time deposits of 30-89 days to 2½ percent for deposits maturing in more than one year and for savings deposits. They remained in effect until January 1, 1957. During this period, the ceilings

received little notice because ample reserves were available to the banking system and market rates of interest were well below the posted ceilings. By 1955-56, however, the rates paid by banks on time and savings deposits were pressing against the ceiling, and banks were losing out in the competition for loanable funds.

By the end of 1961, banks were again pressing against the ceiling in seeking funds. As a consequence, Regulation Q and the corresponding FDIC regulation 329 were amended on January 1, 1962, to permit higher rates on deposits of more than 6 months' maturity. An additional consideration at this time was the outflow of short-term capital from the United States in search of higher returns abroad. The heavy flow of domestic savings, unused manpower resources, and idle plant capacity all combined to hold domestic interest rates down, while interest rates abroad were moving up because of the scarcity of capital and strong internal demands for funds. The upward revisions in the interest rate regulations in July 1963 and again in November 1964 therefore were designed primarily to discourage the outflow of funds from the United States, which would increase our payments deficit. Thus, after years of relative obscurity, interest rate regulations moved into a more prominent role in influencing the flow of funds both domestically and internationally.

The domestic impact of interest rate changes on the liability structure of banks has been particularly spectacular. The growth of time and savings deposits of commercial banks since 1957 can be attributed in large part to the payment of more competitive rates by banks in relation to the rates offered by other financial institutions or to the yield on other money market instruments. The ceilings have been raised to bring

commercial bank rates into line with market rates and to equalize competition among financial intermediaries, rather than to influence or set the level of rates. Changes have been made within particular maturity ranges from time to time to permit banks to tap various sources of funds, such as those at the disposal of corporate treasurers, while the banks themselves have been innovators in developing new methods of attracting and retaining funds.

The most notable development in recent years has been the negotiable time certificate of deposit, which since 1961 has become a money market instrument that competes effectively with Treasury bills, commercial paper, and similar money market investment outlets for the short-term investor's funds. Negotiable CD's provide a flexible means for adjustment of a bank's short-term requirements for loanable funds. At the same time, they provide a liquid, convenient, and relatively safe investment medium for business firms, state and local governments, and others that have substantial sums to invest at short term. Wisely used, negotiable CD's can enhance the ability of an individual bank to tailor its deposits to the demands on it for credit accommodation. They increase the efficiency with which short-term funds can be channeled into productive uses.

The use of negotiable CD's, however, is not without problems -- which can vary by size of bank or according to the prevailing general economic situation. Large banks have some advantage over smaller banks in attracting funds because of their better-known names and the consequently wider market for their CD's. They also have somewhat greater adaptability in the management of their portfolios in the event of unforeseen contingencies. Nevertheless, the smaller bank also has used CD's advantageously.

Unfortunately, however, a few banks have engaged in undesirable practices in soliciting funds.-- paying money brokers, funders, or other persons, including at times the depositors, compensation in excess of that permitted under Federal Reserve and FDIC regulations. These high-cost funds have in turn been employed in highly risky and illiquid loans. Let me emphasize, however, it is not the CD's themselves that create the problem. It is primarily the deliberate intention of engaging in undesirable practices that has been responsible for the difficulties that subsequently developed for the banks involved. I would like to stress that the great majority of banks have observed faithfully and conscientiously the interest rate regulations and have not attempted to circumvent the spirit or letter of the law.

Nevertheless, because of the abuses and because of the crucial role that interest rate regulation can and does play in influencing domestic and international flows of loanable funds, some means of effectively enforcing the interest rate ceilings is eminently desirable -- even just for the recalcitrant few. Existing penalties or refusal to extend insurance coverage to the deposits involved on legal grounds are inefficient or tend to foster other problems. Consequently, after consultation with Federal Reserve and Treasury officials, I submitted to Congress early last August a draft of proposed legislation to strengthen the enforcement provisions of the interest rate regulations of the Corporation and the Federal Reserve.

The proposed bill would amend the Federal Deposit Insurance Act and the Federal Reserve Act so as to provide effective penalties for violations of federal regulations prescribing the maximum rate of interest which insured

banks may pay on deposits. Under the proposed legislation no insured bank or officer, director, agency, or substantial stockholder thereof would be permitted to pay or agree to pay a broker, finder, or other person compensation for obtaining a deposit for the bank, except as the Board of Directors of the Corporation or the Board of Governors of the Federal Reserve System may by regulation prescribe. Any payment made by any other person to induce the placing of a deposit in an insured bank would be deemed to be a payment of compensation by the bank if the bank has or reasonably should have knowledge of the payment by such person when it accepts the deposit. Any violation by an insured bank of the prohibitions in the law or regulations issued pursuant thereto would subject the bank to a penalty of not more than 10 percent of the amount of the deposit to which the violation relates. The Corporation and the Board of Governors of the Federal Reserve System would be empowered to recover these penalties, by suit or otherwise, together with the costs and expenses of recovery. The Board of Directors of the FDIC and the Board of Governors of the Federal Reserve System would define what is meant by "payment of interest." Enactment of this piece of legislation will contribute to a strengthening of our banking system and of public confidence in our banks.

The commendable performance of bankers to date -- their imagination, resourcefulness, progressiveness, and adaptability -- as exemplified by the generally prudent development and use of negotiable certificates of deposit, testifies to the dynamism of our banking system. This record should not be obscured by the actions of a small minority. The administration of Regulation Q and 329 by the bank regulatory agencies provides a good illustration of the benefits that can be derived from the considered use of administrative

regulations in response to the legitimate needs of banks and the economy in a manner that serves the public interest.

Before I end, I should like to make one final observation. In the period of time I have served on the Board of Directors of the Federal Deposit Insurance Corporation, my appreciation of the depth and vitality of the American system of banking has continued to grow. As a supervisor I have had a unique opportunity to see the great strength of this system. Progressive managements, improved techniques of control and operation, increased services to the public, all stress the good, sound job the industry is doing.

I pledge to you that the FDIC is firmly resolved to continue its posture of support and maintenance of high standards. Through a continued dedication to standards of excellence by banks and supervisors we can be assured of continued strength, stability, and freedom in American banking.

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