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SAVINGS: A "NEW LOOK" TO AN OLD CONCEPT

An Address By

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before the

NATIONAL SAVINGS CONFERENCE
of the
AMERICAN BANKERS ASSOCIATION

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SAVINGS: A "NEW LOOK" TO AN OLD CONCEPT

I am very pleased to be invited to address your 63rd annual National Savings Conference. Banks have played a major role in promoting savings and in directing these savings into productive uses in the current economic expansion--an expansion now in its sixth year, a record surpassed only during World War II. The role of banks as financial intermediaries, moreover, will become increasingly important in the years to come as banks steadily broaden their loan facilities and expand their range of services. Your program, therefore, appropriately focuses on strengthening the competitive position of banks in the savings market. At the same time, however, it does not neglect other important considerations facing banks in the competition for savings funds--particularly the cost of these funds to the bank and their profitable employment.

The efficient and effective mobilization of our financial resources has been a major source of strength in the current expansion of business activity and is essential to continuation of balanced growth. Banks have made, and are making, a significant contribution to the smoother flow of funds from savers to borrowers. Your task has been eased to some extent by supportive legislation and regulatory decisions, but a thorough understanding of the role of savings in the economy and of the changing nature of savings over the past several years is even more important in achieving optimal employment of the nation's savings.

Before discussing some of the changes that have taken place, I would like to define my terms a little more explicitly--terms which are familiar to the banking fraternity but terms which are used rather imprecisely by the layman. Savings in the broad monetary sense is that portion of income--a pool of funds--of individuals, business firms, and Government which is not currently consumed. These funds are available for productive investment, either directly or through financial intermediaries such as banks and specialized thrift institutions. It is this pool of savings for which financial institutions compete with one another and with other potential borrowers in the savings market. Banks compete through the offer of various time deposit facilities--the familiar passbook savings account, open account time deposits, and, more recently, negotiable and nonnegotiable certificates of deposit.

Bank competition for savings serves the private as well as the public interest. The increase in time deposits at banks has been an important factor in bank growth. And if banks want to continue to share in the task of satisfying the economy's rising demands for credit--both larger in size and more varied in nature than ever before--they must grow. As a consequence, they must be prepared to compete against other financial institutions for savings and to employ these savings effectively. In the process, bank management will face new problems and new opportunities.

The bank quest for savings is particularly topical because of the intensity of the current rivalry for funds between financial institutions and the appearance in the past several years of new methods to tap the savings market. The heavy demand for credit--and therefore for loanable funds--reflects the stepped up requirements of the Vietnam conflict added to the demands already being made on an economy approaching full employment. These demands in turn have been reinforced by the expectation in some sectors of the market that further increases in interest rates and prices are inevitable unless more stringent monetary and fiscal restraints are applied to the burgeoning economy. But I question the inevitability of this sequence of events.

Credit demands are strong, and most statistical indicators of economic activity continue to chalk up new highs. But the move toward moderate credit restraint by the Federal Reserve last December, enactment of the President's tax proposals, and expected additions to the labor force and to plant capacity this year could well temper the upward pressures sufficiently to permit a continuation of the well-paced advance of the past five years. We are finding ourselves in an unaccustomed and enviable position--but a position requiring greater finesse and greater vigilance if we want to preserve the balanced nature of the expansion and forestall the emergence of unsustainable pressures on plant and manpower capacity and on prices. An informed view of the overall economic situation and of conditions in the financial markets is essential.

As the head of the bank supervisory agency entrusted with certain responsibilities over all insured banks--national and state--I would like to list briefly what I think have been some of the major developments in the savings market over the past several years and what the implications might be for the future.

The kinds of financial institutions actively seeking savings today are little changed from those in existence at the end of World War II. But all these institutions, with the exception of the postal savings system, have grown in size. Deposits held by mutual savings banks more than doubled in the almost 20 years that have elapsed since 1946. Time deposits at commercial banks have increased more than three times over the same time span. Share accounts of savings and loan associations are 12 times larger than in 1946.

Since 1957, however, when Regulations Q and 329 governing maximum rates payable by commercial banks on both savings and time deposits were liberalized, the specialized thrift institutions have tended to lose ground in the competition for savings.

The success achieved by banks in attracting a larger volume of savings has enabled them to supply a larger proportion of the nation's credit requirements. Commercial bank credit has risen on the average of $8\frac{1}{2}$ percent per year since the end of 1960. It has accounted for over one-third of the funds supplied by the credit markets in recent years, compared to one-sixth in the immediate post-Korean period when credit demands were also strong.

Concentration of a rising share of credit demands on banks has been due to several circumstances: the diversified lending facilities and services offered by banks, liberalization of the permissible ceilings on time deposit rates, and an ample supply of reserves provided by Federal Reserve operations. And these demands on banks will remain large as long as they can satisfy the financing requirements of the economy efficiently.

Not only has the volume of savings grown and more of the credit demands centered on banks but the nature of the savings market has changed significantly within the past several years. Time and savings deposits were formerly a highly stable element in bank liabilities. Time deposits provided the holder with a safe, long-term investment outlet with a dependable, if small, yield. But a new factor has entered the picture as the economy has expanded and savings have increased. Holders of temporarily idle balances--such as corporations--began to seek ways to employ this short-term money profitably at about the same time that financial institutions sought to expand their activities.

Worthy of emphasis at this point is a recent blurring in the concept that savings and time deposits at commercial banks consist of the traditional "savings" of individuals and business firms. "Time money" now includes a significant volume of funds available primarily for short-term investment. They are funds not needed for current comsumption, it is true, but, unlike the more stable "savings" accumulated in the past to prepare against unforeseen contingencies or to finance major capital expenditures, these "savings" are often working balances previously held in inactive form in demand balances and now invested in short-term interest-bearing assets. Accordingly, time money is no longer the more or less homogeneous "savings" of earlier years. This change has important implications for deposit behavior in banks and for bank management.

With their broader lending powers, banks have pioneered in the mobilization of these idle short-term balances. Their success in tapping this source of loanable funds--primarily through large, negotiable time certificates of deposit but also through repurchase agreements with corporations, the issuance of unsecured notes, and similar innovations--has permitted the fuller utilization of our financial resourses. More recently, smaller denomination savings instruments have been introduced by banks to attract the interest-sensitive funds of small savers.

Some of these innovations might be considered "gimmicks." But a number of them may eventually become a permanent feature of the financial markets. Until they have been fully tested and their value proven, they should be used with caution. The unwise use of small-denomination savings instruments, for instance, could create numerous problems for the unwary bank.

The altered character of time money has made time deposits as a whole more volatile and more sensitive to changes in interest rates.

Time money in the form of negotiable certificates of deposit, for instance, are more like a money market asset to the holder and less like the traditional savings accounts. The growth in time money and its different character have a major impact on three major areas of bank operations: the composition of bank portfolios, the intensity of competition among financial institutions, and bank costs and earnings.

Time deposits are much more important now to banks in all deposit size groups, and their relative importance has grown most rapidly for large banks. There is less variation now in deposit mix by size of bank. The larger volume of time money has enabled banks to engage more extensively in financing of mortgages and consumer instalment purchases and in term lending to business. The relative stability of time deposits until recently reduced the need for cash balances and permitted more investments in earning assets. Loan/deposit ratios climbed partly for this reason. U. S. short-term Government security holdings were worked down from the abnormally high levels of the period immediately following World War II and were partly replaced by higher yielding state and local government securities.

The growing importance of the more volatile CD, however, has tended to dampen these changes, particularly at this time when banks are finding it increasingly difficult to sell longer term CDs. A somewhat greater degree of liquidity may be necessary to carry banks through periods of short-term pressure on their CD positions in order to avoid sharp changes in their security portfolios or in their lending activity. The problem is a fundamental one of determining the proper balance between liquidity and the maintenance of asset yields that will compensate for the higher cost money.

Because lending and investment opportunities have multiplied, competiton among banks and between banks and other financial institutions has intensified both in the extension of credits and in the solicitation of idle balances. Banks have moved into fields formerly serviced exclusively by nonbank financial institutions, while the nonbank financial intermediaries are moving in the direction of more liberal lending and investment powers. In the money market too, commercial banks vie for funds with other borrowers, such as commercial and finance companies and the U. S. Government.

Competition among banks has occurred both on the purely local level and in larger regional and national markets. A recent study completed within the FDIC indicates that "local" competition among banks alone might be most appropriately defined by the competition for demand deposits of individuals. partnerships, and corporations in accounts of $10,000 or less--and possibly by time deposits IPC in the same deposit size category. But for time deposits, the competition of nonbank financial intermediaries is a major factor that cannot be ignored in looking at a bank's relevant market area. For larger accounts, the study demonstrates that meaningful market analysis must also include competitive factors beyond the immediate local market.

Time money has added also to bank costs and has tended to depress bank earnings. Some relief should be provided, however, by the recent increase in the prime lending rate. The interest cost burden is of course greatest for banks with the largest proportion of time money. But it is also influenced by the forms of time money held--passbook savings accounts or negotiable CDs, for instance. Higher rates on only certain types of time deposits are obviously less costly than higher rates applicable on all deposits. In any event, higher interest costs will bring about portfolio adjustments, which could affect credit quality or liquidity adversely if higher yields only are the governing consideration.

But banks also can find opportunities to cut costs, offer new revenueproducing services, or increase earnings through a larger volume of business. The latter alternative, however, is not available to all banks, particularly the smaller bank which may have limited access to lending and investment opportunities but which nevertheless must pay higher rates in order to retain its time deposits.

But these statements do not tell us much about what we really need to know about time money. Does bank management, for example, have any reasonably accurate idea how much time money actually costs them and what its contribution is to bank revenues? Does a bank have enough information available to determine how much an additional dollar of deposits--whether demand or time--contributes to costs and to revenue? And what is the cost of alternative sources of funds--such as sale of capital notes or debentures or stock? Few major studies have been conducted in this area, but the available literature indicates that the answer may vary by size of bank.

In the past, the general impression has been that small banks as a group are harder hit by high interest rates on time deposits than large banks because small banks are more restrictdd in their alternatives for investment and are less flexible in their operations. Statistics collected by the Corporation on all banks, however, indicate that the largest banks may also be relatively hard hit by higher rates on time money--at least in the short run. There may be several reasons for this. The proportion of time deposits has risen much faster in the large banks than in small banks. Large banks have been most active in the high-cost CD market. And even for the large banks that have achieved significant savings in labor costs, profit margins have shrunk because of the time it takes to make the necessary portfolio adjustments.

Small banks, on the other hand, may not fare as badly as we think. Their location outside major money market centers oftentimes protects them to some degree from pressures to match rising market rates, and the average small depositor in these banks tends to be less responsive to interest rate changes and differentials. The entry of smaller banks into the market for small-denomination savings instruments, however, may expose them to stronger competitive pressures. These tentative assessments are based on an examination of aggregate figures, which oftentimes hide as much as they reveal, and no doubt wide variations occur even among banks of the same deposit size. But available evidence tends to provide support for these conclusions.

To find out more about this important subject of costs, we have begun a pilot study on the determination of bank costs. We hope the study will produce some useful results which can be made available to the banking industry, to supervisory agencies, and other interested parties.

At the present stage of the business expansion and in light of the changes in the savings market, it is important that banks remain conscious of their responsibility to help sustain a balanced expansion. It is a responsibility that incidentally carried with it a large element of self-interest. Bank competition for funds should as always be determined by each bank's ability to utilize those funds productively.

But even those banks currently facing strong demands for credit must exercise selectivity in extending credit for otherwise productive uses that would not add to the immediate supply of goods and services but only to pressures on capacity and prices. The competition for loanable funds, moreover, should be pursued with full cognizance of the cost burden entailed, the possible volatility of the funds, and the relative scarcity now of high-quality investments. This is a time for bank management to take an objective look at the quality of loan portfolios and at the nature of the funds being used.

I would like to take note of one last point before closing. Much of the recent discussion concerning the impact of time deposit rates on banks has stressed its effect on bank costs--to the neglect of its price funtion and its role in helping to implement monetary policy. Interest paid to depositors constitutes a cost to the bank, but the same rate is a price offered to current and potential depositors. The recent boost in the Federal Reserve's discount rate, moreover, was designed to bring the rate into more realistic alignment with market rates and at the same time exercise some restraint on credit expansion. The effect on bank costs was to some extent merely a byproduct. The resultant rate structure operates on the supply side to increase the supply of funds to the banks and on the demand side to discourage some marginal borrowers.

The increase in Regulation Q and 329 ceilings complemented the discount rate increase and was consistent with the discount rate action. These regulations have served in the past to protect banks against upward cost pressures and have also been viewed as safeguards against unwise lending and investment practices arising from competitive pressures. But the primary purpose of the two regulations is to make monetary policy effective--and not to relieve pressures on bank earnings.

I would like in conclusion to commend your banks for their excellent record of response to the recent changes in the competitive environment. In general, your operations have adapted to changes in the economic situation and in the banking and financial system promptly, imaginatively, and responsibly. But conditions are constantly changing, and we must all remain alert to new developments. This year new savings may fall short of demand. Upward pressures on interest rates therefore will tend to persist. Your response will have to be tailored to meet this situation. Higher rates may provide some relief by cutting back less essential demands, if higher rates fail to elicit any substantial flow of new savings.

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