Statement of
Chairman K. A. Randall
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before the
House Banking and Currency Committee
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Mr. Chairman, I am pleased to have the opportunity to submit to the Committee the views of the Federal Deposit Insurance Corporation on that part of H.R. 12754 that is the Administration bill and therefore relates to the Corporation. The relevant provisions of the bill "extend for two years the authority for more flexible regulation of maximum rates of interest or dividends, higher reserve requirements, and open market operations in agency issues."

The Act of September 21, 1966 (80 Stat. 823), among other things, provides the statutory flexible authority mentioned above for regulating interest and dividend rates which may be paid by insured banks and by insured savings and loan associations on time and savings deposits or shares or withdrawable accounts. Additionally, the Act authorizes the Board of Governors of the Federal Reserve System to increase reserve requirements on time and savings deposits to a maximum of 10 percent and authorizes Federal Reserve open market operations in obligations of agencies of the United States Government.

The Act was effective for only one year, beginning on September 21, 1966, the date of its enactment. The purpose of H.R. 12754 is to extend this period for another two years, so that the Act will remain in effect until September 21, 1969.

This legislation is concerned with interest rates. Among the many facets of the interest rate problem, the general level of rates and interest rate competition for savings between financial institutions have commanded most attention over the past year or two. The legislation under consideration, however, pertains primarily to the relationship of the regulatory ceilings to interest rate competition for deposits between competing financial institutions--rather than the general level of interest rates. Because the Corporation is charged with the responsibility for establishing rate ceilings on time and savings deposits of FDIC-insured banks not members of the Federal Reserve System, my remarks today are directed chiefly to this area.

This is not to deny that the level of interest rates is of vital importance to the economy--as well as to the individual borrower and saver. But regulatory ceilings are not designed specifically to influence directly the general level of interest rates.

The subject of interest rates is more complicated in scope and nature than is generally recognized. Thus, there is one aspect of interest rate competition that does have a bearing upon the general level of rates, which should be brought to your attention. Unrestrained competition for the savings dollar during a period of high interest rates can induce a feedback effect, which tends to cumulate and cause a further escalation in interest rates generally. This feedback phenomenon is not readily quantifiable. But bankers and others familiar with the workings of the financial markets are fully cognizant of the fact that intense competition for savings can in these circumstances engender upward pressures on all rates.

With some restraint placed on competition through rate ceilings on certain categories of time and savings deposits, for example, the feedback effect can be dampened or even checked. Accordingly, even though the legislation before your Committee operates directly only on the competitive situation with regard to interest rates, it can help, nevertheless, to exercise some calming influence on the general level of interest rates.

The greater flexibility accorded the banking agencies to vary rate ceilings on time and savings deposits on different bases and the extension of rate ceilings for the first time to insured member institutions of the Federal Home Loan Bank System and to mutual savings banks have strengthened the ability of the financial supervisory agencies to influence competition between these various institutions. Nevertheless, the effectiveness of this broadened authority is still subject to some significant constraints, which limit the extent to which the rates payable on time and savings deposits--and the competitive situation in the market for savings--can be controlled. These limitations must be explicitly recognized in assessing the effectiveness of the flexible interest rate authority.

The legislation enacted last year and under consideration for a two-year extension covers only one segment of the financial community. Noninsured banks--some of them quite large--and certain other nonbank financial institutions are outside the scope of this legislation.

Nevertheless, the sector of the financial community covered by the proposed legislation is a vital and a major one. In times of change, such as the present, the ceiling rate authority can be an important element in maintaining orderly conditions in this crucial segment of the money market.

The existence of a public or general market for funds outside the depositary-type institutions constitutes another limitation on the regulatory authorities in administering the rate ceilings. This general market comprises short-term commercial paper floated by business firms and purchased by lenders seeking temporary employment of idle balances, and shares and bonds of private business traded on the organized exchanges or over-the-counter, as well as the market for U.S. Government obligations. In addition, it includes mortgages, notes, and other evidences of debt or property rights that individuals may use as investment outlets. In this broader market is reflected the various market pressures for funds for all uses, adjusted, of course, for each instrument to the circumstances of the individual commitment.

Because banks and other thrift institutions are but a part of this larger market, the regulatory authorities can ill-afford when establishing rate ceilings to be unmindful of interest rates in that part of the general market beyond the reach of their controls. If the ceilings are so unrealistic as to render the regulated financial institutions noncompetitive in this market, funds will be diverted to that segment of the market offering relatively more attractive investment opportunities.

The persistence of a significant difference between the rates of return on bank time deposits or on share accounts and comparable general market investments therefore could encourage many account holders to shift their funds to more attractive market instruments. In such an event, a corresponding shrinkage in their assets would occur as funds move out of the regulated institutions. Certain loan demands traditionally met by these institutions could as a consequence go unsatisfied. This process is known technically as disintermediation. The flexible features of the legislation under consideration probably offer the most promising means of coping practically with this aspect of the interest rate problem.

At the same time, it should be stressed that the establishment of interest rate ceilings is not an effort to fix prices by government fiat. Rate ceilings only delineate the upper limit for interest rate competition among the regulated financial institutions. The ceilings should, as a rule, allow sufficient leeway for banks to vary rates in response to market conditions and allow for regional and interbank differences. By specifying a maximum and in effect notifying the regulated institutions of the point beyond which added competition would not be in the public interest, the supervisory agencies can help to stabilize the entire structure of interest rates.

Relative stability in interest rates has obvious advantages. In the first place, it minimizes the feedback referred to earlier where excessive competition tends to produce upward pressures on the general level of interest rates. Relative rate stability also facilitates planning by both business enterprises and consumers. No doubt high interest rates that reflect the interaction of demand and supply in the marketplace can be burdensome, but the necessary adjustments can be made. Much more difficult to adjust to is <u>instability</u> in rates, because of the uncertainty which is injected into decisions on investment, saving, and consumption. To the extent, therefore, that interest rate ceilings help to stabilize the structure and level of interest rates, an environment most conducive to a sustainable, high level of economic activity is fostered.

The case for continuing the flexible interest rate authority is strongly supported by our experience of the past several years in the market for savings. Not only has the dollar volume of personal saving increased sharply in the postwar period but so has the need for financing of both new and continuing credit requirements. Commercial banks, which were largely inactive earlier in the postwar period in the competition for new savings because of accumulated liquidity, have reentered the savings market at highly competitive rates as their available funds were absorbed into productive credits. The large business corporations, on the other hand, which were large purchasers of certificates of deposit in the mid-1960's are now finding their internal cash flows inadequate to meet their ever-growing needs for financing. The expansion of the economy over the past several years with its related financial requirements has added further to the competition for a limited supply of funds. As a result, the competition for savings has become very keen from all quarters. In these circumstances, the availability of the flexible rate authority gives the financial supervisory agencies the capability to deal more effectively with the wide variety of situations that could develop in this sensitive area. This authority, moreover, is discretionary--not mandatory--and can thus be activated when needed.

Although the members of the Committee are no doubt conversant with the measures taken by the supervisory agencies under the Act of September 21, 1966, it might be useful to review the record briefly.

Under Public Law 89-597, the Federal Deposit Insurance Corporation and the Federal Reserve last September exercised their authority to establish differential interest rate ceilings by size of deposit for commercial banks. The $5\frac{1}{2}$ percent maximum then in effect was maintained for single-maturity time deposits of $100,000 or more, while the ceiling on time deposits of smaller denomination was lowered to 5 percent. The 4 percent ceiling on regular passbook savings deposits held at commercial banks was left unchanged. Effective October 1, 1966, the Corporation also prescribed a 5 percent maximum rate on dividends or interest paid by FDIC-insured mutual savings banks, with the exception of Alaska where a higher ceiling was permitted. At the same time--and for the first time, the Federal Home Loan Bank Board set ceilings on dividend rates payable by insured savings and loan associations, varying the ceilings in accordance with geographical and other differential patterns characteristic of the pre-regulation period.

By the close of 1966, the disruptive rate competition between financial institutions that reached its peak in the late summer had moderated appreciably. Time deposits held by insured commercial banks at the year-end were a modest $2\frac{1}{2}$ percent above the midyear figure despite deposit losses from September to November. Although the very largest banks found it difficult to compete with the terms offered in the market, they were able to retain nevertheless the bulk of their large (i.e., $100,000 or more) certificates of deposit under the new ceiling structure. Furthermore, the lowering of the interest rate ceiling on the so-called consumer-type time deposits of less than $100,000 at savings institutions helped to alleviate competitive pressures without checking deposit growth. "Other time deposits" at commercial banks increased 9 percent from June to December, while savings accounts declined slightly. A leveling off in the rate of economic expansion also served to limit further escalation of rates.

No major changes have been made in interest rate ceilings since the initial September action. However, in an order effective July 1, 1967, the Corporation reduced the maximum rate of interest or dividends which could be paid by insured nonmember mutual savings banks in Alaska to the same basis as insured mutual savings banks in other States. This change was coordinated with an order effective on the same date by the Federal Home Loan Bank Board, which lowered to 5 percent the dividend rate ceilings payable by savings and loan associations in California, Nevada, and Alaska, with certain permissible exceptions.

Because of the rapidly changing environment during this period, it was obvious to the supervisory agencies that more information was needed in this critical area. Consequently, the FDIC, the Federal Reserve, and the Federal Home Loan Bank Board initiated a series of surveys of their member institutions as early as May 1966. Subsequently, all three agencies conducted surveys as of January 31 and July 31, 1967. Participating institutions were asked to report a breakdown of each type of time deposit or share account and the corresponding rate information.

Included in the information developed from these surveys was the fact that much of the competitive rate pressure was concentrated in a relatively few areas. For the most part, the higher rates were offered by the larger institutions and by those located in major financial centers or in capital-short regions. Commercial banks in metropolitan areas, for example, presumably facing strong competition from nonbank financial institutions and from proximity to financial markets, tended generally to offer higher returns on savings.

Fewer than half the banks issuing time deposit instruments in denominations of less than $100,000 in January 1967, moreover, offered the maximum rates permissible, although almost three-fourths of the dollar volume was accounted for by the larger banks at the ceiling rate. In addition, the growth in time deposits at banks resulted from more banks entering this field as well as from increases in rates offered by banks already in this market.

The surveys also revealed that the success with which banks were able to attract business-type deposits (certificates or open accounts with balances in excess of $100,000) tended to vary inversely with the movement of yields on competing market investments. By the time of the January 31 survey, for example, banks were able to attract large business deposits at offering rates under the 5½ percent ceiling on all maturities and a substantial amount at longer term.

Two relatively distinct markets for large certificates of deposit were also noted by the surveys. One is the national money market, where buyers are mainly leading industrial corporations and other large investors and where rate rather than customer relationship governs the placement of most funds. The second market--and apparently one of growing significance--is more localized and is comprised mainly of businesses of medium and small size which commit their funds for short periods to open account time deposits and small certificates of deposit. Somewhat surprising was the relatively wide range of interest rates offered on the larger balances.

The profile for the insured mutual savings banks was very similar to the experience of consumer-type savings deposits in commercial banks over the survey dates.

On the basis of reports from about two-thirds of the insured nonmember commercial and mutual savings banks in the latest survey of July 31, regular passbook savings showed an increase since the beginning of the year of about 3 percent, with passbook savings rates virtually unchanged. At the same time, consumer-type savings spurted by about 13 percent although rates were generally stable over the period. In the business-type time-deposit category, on the other hand, approximately 10 percent of the insured nonmember banks reduced their maximum rates while these deposits expanded slightly.

Almost complete returns from FDIC-insured mutual savings banks for the same date showed regular savings about 5 percent higher than in January. The rate changes reported generally tended to cancel each other out so that the proportion of deposits at the ceiling rate remained virtually unchanged. In general, mutual savings banks did not seem to have experienced any significant change in deposit structure since the beginning of the year.

Because market rates of interest have fluctuated sharply since the July survey date, the Corporation conducted a limited survey of selected insured nonmember commercial and mutual savings banks during the week of September 5. No changes were made by any of the mutual savings banks queried. About four-fifths of the 150 commercial banks in the sample reported no change in rates since the July survey. Of the remaining banks, slightly more than half lowered rates on at least one type of deposit and a somewhat lesser number raised rates. All of the changes but one involved time deposits other than regular passbook savings. The largest banks again accounted for most of the interest rate changes. Rate increases were put into effect mainly for consumer-type instruments, while rate reductions generally affected business-type deposits. A lessened demand by banks for short-term deposits because of the recent slowdown in business loan demand and some interest in longer maturities because of uncertainties about the longer term outlook were probably responsible for the relatively high incidence of rate changes in the sample.

Developments in the market for savings and in the economy since September 1966 demonstrate clearly the need for the financial supervisory authorities to remain flexible to changing circumstances. Within a relatively short space of time, we have seen the individual saver, business corporations, and financial intermediaries modify their customary patterns of spending, saving, borrowing, or marketing in response to changing economic conditions. With the prospect of a resumption of economic expansion later this year and some change in the mix of fiscal and monetary policy, conditions in the financial markets cannot be accurately predicted. Although present interest rate differentials between depositary-type savings instruments and other investments have apparently not been wide enough to induce any widespread switching from claims on intermediaries into market instruments, the situation could change almost overnight.

Market forces have always been the primary factor in the allocation of funds among competing users, and the market mechanism has proved adaptable to the changing demands of the market. Individual participants in the market--whether on the demand or supply side--must therefore also adapt or lose their ability to compete in the market-place. The nature and direction of their responses cannot be readily anticipated. Therefore, it is essential--when the pace of change is accelerating--that the financial supervisory authorities be prepared to be flexible and responsive to any developments.

The legislation being considered today will contribute to our ability to maintain such a posture. Extension of the flexible interest rate authority would greatly assist the financial supervisory authorities in the discharge of their statutory responsibilities. Accordingly, the Corporation heartily endorses enactment of that part of H.R. 12754 relating to the extension of interest rate control legislation.

We have been advised by the Bureau of the Budget that there is no objection from the standpoint of the Administration's program to the submission of this statement.

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