NEWS RELEASE

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FEDERAL DEPOSIT INSURANCE CORPORATION

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PR-36-79 (4-11-79)

Statement on

S. Con. Res. 5

Requesting the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, and the Federal Home Loan Bank Board to reduce the adverse impact of Regulation Q on depositors and account holders with small deposits and accounts.

and

S. Res. 59

Relating to the minimum denomination of savings certificates which bear interest at a rate indexed to Government securities interest rates.

Presented to

Subcommittee on Financial Institutions
of the
Committee on Banking, Housing and Urban Affairs
United States Senate

by

Irvine H. Sprague, Chairman
Federal Deposit Insurance Corporation

April 11, 1979

Room 5302, 10 a.m.
Dirksen Office Building

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Mr. Chairman, your committee has before it today two resolutions -- S. Con. Res. 5 and S. Res. 59 -- which you, Mr. Chairman, and Chairman Proxmire have introduced respectively to help the small saver. The language of both resolutions is very simple and straightforward. S. Con. Res. 5 calls upon the regulatory agencies to provide an appropriate method by which the interest on small saver accounts is increased equitably in order to reduce the adverse impact of regulated rates on the holders of such accounts. S. Res. 59 would express the sense of the Senate that the regulators should reduce the minimum to $1,000 on any certificate of deposit whose interest rate is tied to a government securities rate.

It was in response to these and other urgings that the regulators took the actions we did last week to make specific proposals for relief for the small saver. Our proposals would not provide all the relief contemplated by the two resolutions introduced by yourself and Senator Proxmire, Mr. Chairman, but we hope that whatever we implement will take a long step toward achieving your objectives.

In my opinion, it is unconscionable to continue a system wherein a big saver with $100,000 to invest earns interest at a rate twice as great as the small saver with $1,000 or less.

It is equally unconscionable to react to this situation in such a precipitous fashion that we jeopardize the future of the savings bank industry.

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We will do something to alleviate present conditions. And I predict that when we do, the following will happen:

(a) the small savers will say we didn't do nearly enough,

(b) the savings institutions will say we did far too much,

(c) the commercial banks will have a mixed response,

(d) the regulators will be very uncomfortable,

(e) the Congress will be critical, and

(f) the press will follow all this avidly, looking for confrontation.

A recent New York Times editorial highlighted our dilemma:

> Thus the regulators are trapped between their obligations to savers and their obligations to the savings institutions. If the interest paid to depositors were allowed to rise, as fairness dictates, the savings banks and savings and loans could end up paying 9 to 10 percent to many depositors while the mortgages they wrote years ago keep returning only 6 or 7 percent. If, on the other hand, they were to maintain low ceilings on interest, the savings institutions would remain healthy at the expense of many depositors.

As things now stand, these are the kinds of accounts that financial institutions are authorized to make available to their depositors:

-- the passbook account on which commercial banks may pay five percent interest and thrifts five and a quarter percent,

-- a $10,000 minimum 6-month certificate of deposit bearing interest at the weekly money market rate for 6-month Treasury bills plus a modified differential for thrifts,

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-- a $100,000 minimum certificate of deposit with a maturity of as little as 31 days with interest at the market rate,

-- a series of certificates of deposit with maturities ranging from 90 days to 8 years or more; interest for the shortest-term instrument is 5-1/2 or 5-3/4 percent and for the longest-term instrument 7-3/4 or 8 percent for commercial banks and thrifts respectively,

-- government deposits which earn 8 percent interest for all maturities of 31 days or more and

-- Individual Retirement Accounts and Keogh plans which earn 8 percent interest for maturities of three years or more.

This is the range of time and savings deposits that now exists.

SMALL SAVER PROPOSALS

We are now seeking comment on a series of proposals designed to alleviate the inequity to small savers without imposing ruinous costs on the financial institutions. The proposals are:

1. a 5-year certificate of deposit with interest tied to but below comparable U.S. Treasury securities,

2. a bonus savings account paying an extra half percent a year,

3. a rising-rate certificate with a moderate early withdrawal penalty and an interest rate that increases the longer the money is on deposit, and

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4. a reduction to $500 in the minimum for certificate accounts, except for the $10,000 6-month money market certificate, and elimination of all minimum deposit requirements on certificates of less than 4 years (now required only at savings and loans).

We are dealing with a volatile situation, keeping in mind the experience with the $10,000 6-month money market certificate. The regulators authorized it just last June, and in 8 months it attracted more than $100 billion in deposits throughout the nation. No one can accurately predict the effect of the proposals we now have before us so we must move with caution.

COMMENT BY MAY 4

When we put our series of interim proposals out for public comment, we emphasized that none of them are inviolable, that we welcome suggestions on ways to improve the terms and conditions of the proposals while maintaining the balance with institutional soundness. We have made it plain, for example, that such specifics as maturity, rate, penalty or other terms are open to change on the basis of public comment.

In this vein, we would welcome any recommendations that your committee might evolve during the course of its deliberations.

We have asked for comment by institutions and the general public by May 4. As soon as possible after that, we will review all comments and recommendations, decide whether or how to revise the proposals and agree on which of them, or combination of them, to implement.

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LONG-RANGE SOLUTION

None of our proposals is in any way intended to be a permanent or comprehensive solution. What needs to be done in terms of an overall solution, in our judgment, is to phase out Regulation Q and other interest rate controls, an action that would have to be taken by the Congress. We need to set a date now for some time in the future, say 5 or more years, and to work toward it. The ceiling would have to be eliminated gradually as it approaches market rates. Thrift institutions would have to be given more investment powers to provide additional financial services to different kinds of customers, say, consumer borrowers. In the process, we should also phase down the differential between banks and thrifts and eventually eliminate it. We need to do everything possible to prepare the institutions for the transition to a market-rate interest environment and to encourage them to take steps toward that goal.

REGULATORY PERSPECTIVE

Congress first authorized the regulation of interest rates paid on time deposits in the Banking Act of 1933 which gave such authority to the Federal Reserve. The Banking Act of 1935 extended that authority to the FDIC. The purpose at that time was to safeguard the safety and soundness of banks by protecting them from unsound competition. In the mid-1960s the purpose was expanded to foster a flow of funds into the housing mortgage market. The Interest Rate Adjustment Act of 1966 extended interest rate ceilings on a temporary 1-year basis to savings

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and loan associations and provided flexibility to the Federal Reserve and FDIC in exercising their interest rate regulatory functions. The same year, in an effort to enhance the competitive viability of thrift institutions *vis-a-vis* commercial banks, the regulators established lower ceilings for commercial banks. In successive efforts to combat disintermediation of deposits in thrift institutions and thus a threat to the housing industry, the Federal regulators created various kinds of time deposits -- in the fall of 1973 4-year or longer certificates of deposit bearing higher than passbook interest rates and in the winter of 1974 6-year or longer CDs with higher rates still.

In 1973 regulators also had authorized the going rate of interest for large deposits of $100,000 or over, with maturities of 31 days or more. This action has had the effect of making a market alternative available to persons having large sums of money and to encourage these investors to retain their money in financial institutions instead of shifting to other investments that promise greater return.

In 1975 Congress further buttressed the thrift institutions by mandating retention of a differential on existing accounts. The differential was then and remains today a quarter-percent higher rate of interest to be paid to thrift depositors on passbook accounts and most time deposits.

The history of the middle and late seventies has been one of relentless pressure on interest rate controls. As recently as 1976, the 6-month Treasury bill rate was 5.25 percent -- about the same as the passbook ceiling for thrifts. In little more than two years that Treasury bill rate has jumped to 9.496 percent while the ceiling for thrifts has remained at 5.25 percent -- unchanged

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since 1973. The result has been that money has sought means to higher returns, ways to circumvent the Regulation Q ceilings.

Regulators countered by offering still more instruments designed to compete for scarce, increasingly expensive funds.

In mid-1978 permissible rates on public deposits and Keogh and IRA accounts were raised to eight percent, and two new CDs were established -- an 8-year instrument with 7-3/4 percent ceiling for commercial banks and an 8 percent ceiling for thrifts and a $10,000 minimum, 6-month certificate of deposit whose interest rate was tied to the weekly rate on the 6-month Treasury bill. Just last month we eliminated compounding and also eliminated the differential on interest rates over 9 percent on these money market CDs and modified the differential for rates between 8-3/4 and 9 percent.

The flexible interest rate control authority has been extended 13 times by Congress since 1966, most recently until December 15, 1980, by Title XVI of the Financial Institutions Regulatory and Interest Rate Control Act of 1978.

The upshot of all this is that during periods of tight money and high interest rates the small savers have been put at a disadvantage. In many instances, the actions I have described were taken individually in response to individual problems. But the effect of these actions in combination is to shortchange the small saver.

COMPLEXITIES OF THE SITUATION

It should be recognized that the dilemma facing the small saver is not an isolated matter. The problem must be considered

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in the context of the complexities of Regulation Q history and the continuing necessity of its application today. The major policy considerations that constrain the regulators from permitting the market to determine interest rates are the soundness of the thrift industry and the holding down of housing costs.

In our effort to help the small saver, we cannot act recklessly without regard for the danger of disintermediation or the financial health of the depository institutions to which we look for a stable flow of funds to housing. In addition to our housing responsibilities, we have the duty of cooperating with the conduct of monetary policy. Obviously, Mr. Chairman, it is not unusual when these various, major, differing objectives conflict.

MUTUAL SAVINGS BANKS

Our mutual savings bank industry is a case in point. This is the portion of the thrift industry directly subject to FDIC supervision. Since these banks specialize in long-term, fixed-rate mortgage lending, they are not well situated to accommodate an abrupt and substantial increase in interest payments to depositors. These institutions, by and large today, do not enjoy the same diversification of assets and liabilities that commercial banks could employ to cope with dramatic boosts in interest payments.

Before the recent acceleration of inflation and the rapid increase of interest rates of the past 12 months, returns on thrift assets were approaching the point where thrifts might have been able to pay market rates on deposits. Because earning

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assets at thrifts are long-term, only a small percentage are affected in the short run by rising interest rates. Each time interest rates move to new, high ground, as has occurred recently, interest ceilings lag behind market rates. However, at such times, the elimination of interest ceilings could pose a serious threat to thrift solvency. Thus, the present dilemma can be explained to a large extent by the inflation rate and the recent run-up in interest rates.

Before we acted March 8 to trim the compounding and differential costs on money market CDs, our projections showed that mutual savings banks would come out of 1979 nationwide in worse financial shape than at any time in this decade -- and that includes the 1974-75 recession which many feel was the worst since the Great Depression.

We expect our actions of March 8 to help stabilize the condition of mutual savings banks, but it is obvious to us that we must do more to help thrifts improve revenues or reduce costs if we are to look to them for higher payments to small savers.

JOINT ACTIONS TO HELP SMALL SAVERS

I don't want to dwell on the things we cannot do. I am here today to tell you what we are now proposing to do.

On April 3, the Federal Reserve Board, the Federal Deposit Insurance Corporation, the Federal Home Loan Bank Board and the National Credit Union Administration jointly issued a series of proposals for public comment. These proposals seek to strike that beneficial balance by which small savers can be provided

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with greater returns and depository institutions can maintain operational stability. We issued four specific proposals so that institutions and the public would have something concrete to comment on, but at the same time we made it clear that we were completely open to suggestion on any and all of these proposals.

Here are the details of four specific proposals:

FIVE-YEAR CD: We are proposing creation of a new 5-year certificate of deposit which could have a minimum denomination as low as $500 and whose maximum interest rate would be based on a rate for U.S. securities, although it would be held below that rate.

Commercial banks would be permitted to pay depositors a maximum interest rate of one and a quarter percent less than an average 5-year rate for U.S. securities. Thrift institutions would be able to pay their customary quarter percent more than banks. (The ceiling would change each month for newly issued CDs. It would be computed on the first Thursday of each month by the Treasury and would be based on the 5-year rate for securities for the preceding calendar week.)

Under this formula, the computed ceiling for this current month would have been 7.95 percent for commercial banks and 8.20 percent for thrift institutions. With continuous compounding, depositors would have earned annual effective yields of 8.39 percent from banks and 8.67 percent from thrift institutions.

The penalty for premature withdrawal would be forfeiture of six months' interest.

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BONUS SAVINGS ACCOUNTS: Another proposal would permit banks and thrifts to pay individual accounts and those of qualified non-profit organizations a lump-sum bonus of one-half percent on the minimum balance in a savings account maintained during a 12-month period. This bonus would be in addition to the passbook interest of five percent paid by banks and five and a quarter percent by thrifts.

RISING-RATE CERTIFICATE: A third option is creation of an 8-year rising-rate certificate. This certificate, which could have a minimum denomination as low as $500, would pay more interest the longer the saver leaves his or her money in the account. Interest would begin at 6 percent for banks in the first year and rise in four steps to 8 percent for the sixth through eighth years. Thrift institutions would be allowed to pay their quarter-percent differential throughout the term of the certificate. The penalty for early withdrawal would be forfeiture of three months' interest during the first year, but nothing after that.

MINIMUM DENOMINATION: Finally, a fourth proposal would reduce federally required minimum deposits on certain time accounts. The minimum for certificate accounts would be reduced to $500, except for the $10,000 6-month money market certificate, and all minimum deposit requirements on certificates of less than four years (now required only at savings and loans) would be eliminated. The $500 minimum would apply to the proposed 5-year certificates and to the proposed rising-rate certificates. In all instances, depository institutions would continue to be free to set higher minimums as under present practice.

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Mr. Chairman, I would repeat that these proposals are only that. They have been offered for comment so that we can have some guidance when we come to decide on which one or more of them -- or which combination of them -- or which modification of them -- to adopt.

All have their virtues and their drawbacks. Ironically, what one group would consider a virtue, another could call a drawback.

As I said at the beginning, what we ultimately decide to do will benefit the small saver, but it will not achieve full equity for him. Any proposal will present some additional cost to the institutions, but we expect it will be a bearable and justifiable cost.

CONCLUSION

Mr. Chairman, I have tried to give you the broadest possible view of the situation confronting small savers, the administrative options that the regulators now have open to us, the steps we are contemplating, and the legislative options open to you.

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