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Statement on

Regulators' Proposals of April 3, 1979,
to create new types of deposit instruments to help individuals
obtain a higher rate of return on their savings

Presented to

Subcommittee on Financial Institutions Supervision,
Regulation and Insurance

of the

Committee on Banking, Finance and Urban Affairs
House of Representatives

by

Irvine H. Sprague, Chairman
Federal Deposit Insurance Corporation

May 7, 1979

2:00 p.m.

Rayburn Office Building
Room 2128



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Mr. Chairman, it is good to be with you today to consider the problems of the small saver and the institutions which serve them.

As you know, the regulatory agencies last month put out for comment four specific proposals for actions intended to help the small saver while at the same time preserving the safety and soundness of the institutions.

I appreciate the offer of this Committee to share our dilemma as we seek an equitable decision on the question of providing a fair return to the small saver.

To my knowledge, no one takes the position that the small savers are not discriminated against. The question is how to reduce the imbalance.

It is apparent that whatever we do -- even if we do nothing -- the decision will be greeted with anguish and criticism.

On April 3, the Federal regulatory agencies issued for comment four proposals. At the close of the comment period Friday evening, we had received 850 comments, by far the largest response in FDIC history to a regulatory proposal.

We now are reviewing the comments and at the same time seeking to make judgments on the effect of the various proposals in terms of benefits to the saver, the effect on viability of financial institutions, the impact on housing, and other factors.

You have also asked us for our comment on a series of detailed questions. Responses have been prepared to as many as possible in the time available and preliminary answers are given in other cases. These are being submitted separately. In appropriate instances, we will be supplying more complete responses for the record.

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I want to assure you that we share your Committee's deep concern about the problems that these proposals are meant to address.

We will do something to alleviate present conditions, probably in the very near future.

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 commerical banks may pay 5 percent interest and thrifts 5-1/4 percent,

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

-- a $100,000 minimum certificate of deposit with maturity of as little as 1 month with interest at a negotaited 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 1 month or more, and

-- Individual Retirement Accounts and Keogh plans which earn 8 percent interest for maturities of 3 years or more.

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

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SMALL SAVER PROPOSALS

We have just concluded the comment period 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 a 1/2 percent lump-sum bonus 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

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 predict with absolute certainty the effect of the proposals we now have before us so we must move with caution.

SUGGESTIONS WELCOME

When we put our series of interim proposals out for public comment, we emphasized that none of them are untouchable, that we

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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 are, however, committed to move without undue delay.

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, either by eliminating its applicability to certain instruments or by providing for market based ceilings at different deposit maturities so that the ultimate elimination of the ceiling would be a minor event. 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

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them to take steps toward that goal. The Regulation Q Task Force, set up last year by the Administration with representation from the bank supervisory agencies, has been looking at these issues. As you know, its recommendations probably will be along the lines I have just suggested.

## 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 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.

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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.

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 1/4 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 2 years that Treasury bill rate has jumped to 9.570 percent, while the ceiling for passbook accounts has remained at 5.25 percent -- unchanged 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 government deposits and Keogh and IRA accounts were raised to 8 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

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$10,000 minimum, 6-month certificate of deposit whose interest rate was tied to the weekly rate on the 6-month Treasury bill. In March 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 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 preserving the soundness of the thrift industry and holding down housing costs.

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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 where the FDIC has direct 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. Nor are the returns on their loans tied to market rates as is increasingly the case in commercial banks.

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 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,

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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 end 1979 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. The financial situation today adds a new edge to the question of expanding the asset powers of thrifts.

## COURT OF APPEALS RULING

The April 20 decision of the U.S. Court of Appeals adds another factor in our consideration of small saver relief. The ruling declares automatic transfer services in violation of the 1933 Act prohibiting payment of interest on demand deposits. It also held that remote service units utilized by savings and loan associations pursuant to Federal Home Loan Bank Board regulations and share drafts utilized by some Federal credit unions violate applicable Federal laws which prohibit demand deposits drawn on Federal savings

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and loans and Federal credit unions. The court stayed execution of its order until January, 1980, so that regulators and Congress could consider the matter.

Mr. Chairman, you have rightly pointed out that the decision could well have an impact on competitive balance between types of financial institutions. What we do in terms of small saver proposals must be weighed in that context.

Automatic transfer service, or ATS, has spread rapidly since it was authorized on November 1, 1978. We estimate 3,300 -- or about 23 percent -- of the nation's 14,000 commercial banks and 32 mutual savings banks located outside New England now offer the service. Patronage is estimated at more than 750,000 bank customers.

The longer-established share draft service now offered by more than 1,500 credit unions, 7 percent of the total, is used by some 1.2 million patrons. About 6 percent, or 296, of the nation's savings and loan associations offer remote service units, but the number of users is not known.

In addition to the institutions already offering these services, others have spent considerable time and money on preparations to inaugurate the service.

The Court of Appeals decision casts uncertainty on the future of all these transaction accounts, with all that implies for institutions and the public.

Obviously, much is at stake here, and we are now in the process of reviewing the court ruling and its implications

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considering our options for a possible course of action.

The Federal Home Loan Bank Board already has decided to go back to the U.S. Court of Appeals and ask for a rehearing of the case in which it is involved. The agencies involved in the other two cases are seeking an extension of the 14-day filing period for a rehearing, and we would expect to make a decision soon on whether to follow the Bank Board and go back to the Court of Appeals. If we do not, or if we do and are denied a rehearing by the Court of Appeals, we would still have the option of seeking Supreme Court review. Our case will continue to be handled by the Justice Department, and we would need the Solicitor General's permission to go to the Supreme Court.

The legislative route presents an even greater number of choices in terms of the kind of bill we would want to support in Congress.

NECESSITY TO ACT

The economic circumstances which prompted us to issue the proposals for comment a month ago still prevail. These conditions remain today a clear mandate for the regulators to act to provide some relief to small savers caught in an inflationary pinch that has driven everything up except the government-controlled rates of interest they may receive on their savings.

This is not to say that we are unmindful of the cost and administrative burden on financial institutions. We are very much aware that whatever final regulation we impose must be thoroughly justifiable and bearable for the institutions.

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We will consider all sides of the issue during our deliberations on the small saver proposals. We trust you share our opinion that delay is not an answer.

## CONCLUSION

Mr. Chairman, I have tried to give you a broad 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.

Thank you.

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