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Statement on

S. 1347, the "Depository Institutions Deregulation Act of 1979",

Presented to

Subcommittee on Financial Institutions,

*Senate* Committee on Banking, Housing and Urban Affairs, *to*

United States Senate

by

Irvine H. Sprague, Chairman

Federal Deposit Insurance Corporation

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FEDERAL DEPOSIT INSURANCE  
CORPORATION

5302 Dirksen Senate Office Building  
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Mr. Chairman, I appreciate this opportunity to give you our views on S. 1347, the "Depository Institutions Deregulation Act of 1979."

Generally, I support your legislation. I do have some comment.

1. Any extension of asset powers to federally chartered savings and loan associations, as in the bill, should also be given in total to mutual savings banks.

2. The decision on establishing the NOW account interest-rate ceiling and on delaying the phase-out or reimposing any interest-rate ceiling should remain with all the regulators and not be shifted solely to the Federal Reserve Board.

3. The regulators should be given some leeway during the two-year freeze period to expedite the phase-out of interest-rate ceilings should conditions warrant.

4. Usury ceilings are a question probably best left to the states.

5. If variable rate mortgages are added to the bill, specific safeguards should also be written in.

6. NOW accounts should be affirmatively authorized nationally by Federal law.

7. The legislation should be tailored to what can be signed into law by October 1.

We are here today because your Committee has shown a keen interest in the question of interest-rate ceilings and their fairness to all segments of the industry and the banking public.

We are here with some urgency because of recent court decisions. The April 20 court decision invalidates the administrative authorization

for automatic transfer services in banks, remote service units for savings and loan associations, and share drafts for credit unions.

The court has stayed its order until January, but as a practical matter, we do not have that much time because we must act before the end of this session of Congress. The Credit Union spokesmen will tell you their effective deadline is October 1. In any event, we would hope legislative action on this bill could be concluded before the Senate SALT debate begins.

I believe that enacting nationwide NOW accounts is the most practicable and acceptable action you can take and the one most likely to be enacted into law. If you can do more, fine; I just would not like to see the entire package go down because it becomes loaded with too many issues. You are the best judge of what is possible within the time constraints.

Your legislation takes a balanced and innovative approach to dealing with a variety of problems, including interest ceilings, thrift institution powers, the flow of mortgage credit, and the general efficiency of our financial system. If enacted, this bill would contribute importantly to improved resource allocation within our economy and more equitable treatment of depositors and potential borrowers throughout the country.

The proposed legislation sets in motion a process that would ultimately eliminate interest ceilings on deposits. Eventually, they would be raised to levels where such ceilings would cease to be meaningful. That would probably occur sometime before the bill actually eliminates such ceilings. This is an interesting approach which has certain advantages. It gives thrift institutions an

adjustment period and lets them know what is going to happen in the future so that appropriate planning in portfolio policy can occur. At the same time, if the bill is properly amended, these institutions will have the benefit of expanded asset powers which will facilitate these adjustments.

The proposed bill makes a major effort toward broadening the asset powers of thrift institutions. The impact will be greatest for savings and loan associations which do not presently have consumer lending powers. Mutual savings banks have a range of consumer lending powers, varying according to the law of individual states. This bill should be revised to provide greater uniformity and improved flexibility to these institutions. The other asset powers recommended in this bill represent a positive contribution to portfolio flexibility, although the improvement is likely to be modest. All new powers in the bill should specifically be extended to mutual savings banks, although many of these powers already exist under some state law.

My concern with the specifics of the bill, as it has been proposed, is that it may be too restrictive with respect to the interest-rate-ceiling phase-out process. The bill would freeze existing ceilings until 1982. Depending on economic and financial developments, it may be possible to adjust ceilings more rapidly during this period than in the proposed bill, and I believe that the bank regulatory agencies should have the flexibility to move in that direction should economic events warrant it.

I will turn in a few minutes to the specific provisions of S. 1347 and give our comments on modifications we believe would improve the thrust and effectiveness of the legislation.

BACKGROUND

But, first, Mr. Chairman, it may be useful to this Committee to have a brief review of the recent, explosive development of NOW accounts in this decade. There is clearly a public demand for this service.

Automatic transfer service, or ATS, was authorized by the regulators beginning November 1, 1978, and we estimate that in 6-1/2 months some 3,300 -- or about 23 percent -- of the Nation's 14,000 commercial banks and 32 mutual savings banks outside New England have inaugurated the service. The ATS account balances were estimated to total \$6.8 billion in June 1979. Patronage is estimated at more than 750,000 bank customers.

About 1,650 credit unions, some 8 percent of the total, offer share draft service that is used by over one million persons. About one-half of these credit unions are federally chartered; they showed share draft balances of \$783 million in 878,000 accounts at the end of March 1979. About 10 percent, or 200, of the Nation's Federal savings and loan associations offer remote service units.

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

NOW ACCOUNT DEVELOPMENTS, 1970 -- 1979

The creation and implementation of the NOW account resulted, in large measure, from growing competition between commercial banks and thrift institutions for consumer deposits, together with the defeat of the thrifts' efforts to gain authority to offer checking accounts.

In 1970, Consumers Savings Bank of Worcester, Massachusetts, developed a new type of savings account which permits negotiable orders of withdrawal payable to third parties. This new type of savings account, commonly referred to as a NOW (negotiable order of withdrawal) account, differs in two respects from the traditional demand or checking account. First, interest is paid on the balance maintained in a NOW account, which is prohibited by statute for demand accounts. Second, withdrawal may be legally delayed by the institution for 30 days, as for other savings accounts, although depository institutions rarely exercise their authority to require notice of withdrawal.

On June 12, 1972, Consumers Savings Bank introduced NOWs to the public. Two months later, New Hampshire Savings Bank in Concord offered NOW accounts for the first time in that state.

During the remainder of 1972 and 1973, NOW accounts spread rapidly among mutual savings banks in these states but not among other depository institutions which by regulation or law could not offer NOWs.

By early January 1973, nearly one-third of the 168 savings banks in Massachusetts and 20 savings banks in New Hampshire offered NOW accounts. The Massachusetts mutuals were paying the same interest rate on NOWs as on regular savings accounts and were generally charging 15 cents per NOW draft (even though the state's commercial banks were at that time not imposing service charges on demand deposits). In contrast, the New Hampshire savings banks were paying either 3 or 4 percent interest on NOWs, substantially less than on savings deposits, but were not

imposing service charges. Approximately 22,000 NOW accounts existed in Massachusetts' banks in January 1973, with deposits totaling \$45 million, compared with some 2,300 NOW accounts in New Hampshire, with deposits totaling \$1.1 million.

Such NOW growth and acceptance in Massachusetts and New Hampshire, coupled with the restriction of such accounts to the mutuals, quickly resulted in considerable agitation for Federal curtailment or regulation of NOW accounts. Public Law 93-100 of August 16, 1973, sanctioned the offering of NOW accounts by all depository institutions in the two states, Massachusetts and New Hampshire, beginning in January 1974. Regulation of NOWs was divided among the Federal Reserve Board, the FDIC, and the Federal Home Loan Bank Board. Eligible account holders for NOWs were limited by regulation to individuals and nonprofit institutions.

The NOW experiment in Massachusetts and New Hampshire was intended to provide information to be used in future assessments of permitting the payment of interest on demand deposits or extending NOW account powers nationwide.

Interagency discussions on NOW accounts resulted in relatively uniform regulations. Most important, the interest-rate ceiling on NOWs was set at 5 percent for all institutions, thereby forcing Massachusetts mutuals to lower the rate on NOWs from 5.25 percent. Furthermore, the agencies agreed to limit NOWs, to the extent practicable, to residents of Massachusetts and New Hampshire, and to restrict NOW advertisements to those states.

MASSACHUSETTS - NEW HAMPSHIRE NOW EXPERIENCES, 1974 to APRIL 1979

Initially, after gaining the power to offer NOWs, commercial banks generally fought the NOW account movement. Most did not offer NOWs and elected to advertise against NOWs, arguing that consumers' savings would be eliminated if they used NOW accounts. Nevertheless, NOW accounts continued to grow during 1974. Finally, in early 1975, commercial banks yielded to competitive and consumer pressures for this new payment service and began offering NOWs on a broad scale.

At the outset, commercials followed the example of the thrifts, offering 5 percent interest on NOWs and offering the accounts free of charge. However, after incurring tremendous growth in the number of NOW accounts and in their dollar volume during 1975, the commercials began to retreat from free accounts and initiated a trend of charging for NOWs, particularly, by imposing some minimum balance requirements. This occurred at a time when interest rates were falling from their highs of 12 and 13 percent, and banks were seeking to offset profit margin pressures by cutting costs, including NOW account expenses. By 1976, thrifts in the two states were following the commercial banks' lead away from free NOW accounts, although not to the extent of the commercials. In June of 1978, 84 percent of the NOW-offering commercials in the two states imposed charges for NOWs, whereas less than one-half (48 percent) of the NOW-offering thrifts imposed charges.

Through April 1979, 5 years after NOW account powers were extended to all depository institutions in the two states, NOW balances totaled nearly \$2.8 billion in nearly 1.9 million accounts. NOWs were being offered by 506 institutions, 85 percent

of the commercial bank and thrift institutions in Massachusetts and New Hampshire. The average number of drafts written on NOW accounts currently ranges from 9 to 11 per month, an activity level closely resembling the average number of debits per month on personal checking accounts.

For the 28 months ending in April 1979, the average balance in NOW accounts at commercial banks in Massachusetts and New Hampshire was more than twice that at the thrifts -- \$2,478 versus \$972.

NOW ACCOUNT DEVELOPMENTS IN THE REMAINING NEW ENGLAND  
STATES, 1976 TO APRIL 1979

Public Law 94-222 of February 27, 1976, extended NOW authority to the remaining New England states of Connecticut, Maine, Rhode Island, and Vermont. In many respects, the initial phase of NOW account availability in these four states has more closely resembled the current rather than the first-year NOW account experience in Massachusetts and New Hampshire. For example, commercial banks immediately emerged as the dominant NOW account force in the four states, accounting for about 79 percent of total balances in NOWs. Moreover, by April 1979, 75 percent of the commercials and 71 percent of the thrifts in the four states offered NOW accounts, which is like the current situation in Massachusetts and New Hampshire, rather than the initial experience. NOW account balances totaled nearly \$1.2 billion in 397,197 accounts. In marketing strategy, both commercial banks and thrift institutions in the four states have adopted the present strategy of commercials in Massachusetts and New Hampshire, both in service charge and interest-rate patterns.

Nearly 80 percent of the institutions in the four states offered NOWs with a service charge plan in June 1978; virtually all paid the maximum 5 percent rate of interest. The average number of drafts drawn on NOW accounts in the four states was somewhat larger than the Massachusetts and New Hampshire experience, indicating more rapid acceptance of NOWs as a third-party payment instrument.

NOW account balances in all New England institutions, amounted to \$3.9 billion in more than 2.2 million accounts for an average balance of \$1,733 on March 31, 1979. Eighty percent of all depository institutions in New England that could offer NOW accounts did so. Other than initially in Massachusetts and New Hampshire, banks in New England have not hesitated to offer NOW accounts, suggesting that commercial banks around the Nation would move rapidly to offer them if such authority is provided.

#### NOW ACCOUNT AND ATS ACCOUNT DEVELOPMENTS IN NEW YORK

ATS authority was provided to all commercial banks and savings banks on November 1, 1978, (by regulation), and NOW accounts were authorized for New York on November 10, 1978, (by Public Law 95-630).

About a quarter of New York's 222 insured commercial banks are offering the ATS service, according to the results of a survey by the New York Federal Reserve Bank. More than half offered NOW accounts. Balances in their NOW accounts totaled \$1.6 billion in 196,700 accounts for an average balance of \$8,145 on April 30, 1979. Some banks offered both ATS and NOW account services.

Nine of the 112 savings banks in New York offered the ATS account service, seven of which also offered NOW accounts. Another 55 percent offered only NOW accounts. Balances in their NOW accounts totaled \$109 million in 112,470 accounts, for an average balance of \$970 on April 30, 1979. Twenty-nine percent of the 126 savings and loan associations in New York offered NOW accounts on April 30. Balances totaled \$35 million in 32,956 accounts, for an average balance of \$1,074.

Next I would like to comment on specific provisions in S. 1347, as introduced.

TITLE I -- PAYMENT OF INTEREST ON DEPOSIT ACCOUNTS

Title I would remove the Federal prohibition on interest-bearing NOW accounts for individual and nonprofit-organization depositors in all insured banks and savings and loan associations and on comparable share draft accounts in credit unions. The effect would be to permit depository institutions nationwide to offer NOW accounts if otherwise permitted under Federal and state law. We support this objective. However, we foresee potential for a problem if applicable Federal or state law does not otherwise clearly authorize such accounts for particular types of depository institutions. Therefore, your Committee may want to give consideration to an affirmative approach in S. 1347 which would expressly authorize all federally regulated depository institutions, whether federally or state-chartered, to offer NOW accounts.

In any event, we believe that a transition period would be useful to permit institutions to adjust to NOW accounts, and we would recommend that the bill be amended to authorize NOW accounts

effective 6 months after enactment and to delay the effective date of the court decision as necessary to accommodate.

This, together with the provision already in the bill limiting NOW accounts to individuals and nonprofit organizations, would help minimize the likelihood of adverse effect on institutions.

Also, we would draw the Committee's attention to a modification which the bill would make in the existing definition of NOW accounts. The bill would define NOW accounts, in part, as accounts from which "the depositor is allowed to make withdrawal by negotiable or transferable instrument for the purpose of making payments to third persons or otherwise." (Underlining added.) The two underlined words are new and could be interpreted broadly. We would recommend either deleting the words "or otherwise" or specifying more precisely what this terminology is intended to cover.

#### INTEREST CEILINGS ON NOW ACCOUNTS

Section 106(a) of the bill would mandate a statutory uniform interest-rate ceiling on NOW accounts for all depository institutions which would be one-quarter percentage point below the lowest rate ceiling prescribed by the Federal Reserve under its Regulation Q. The lowest rate, under the regulators' actions effective July 1, will be 5 percent for NOW accounts, which would mean that NOW interest rate ceilings under the bill would be reduced to 4.75 percent (except in New England and New York where the existing 5-percent rate would be grandfathered). This would not seem to be the intent of the legislation, and we suggest the bill be amended to specify the commercial passbook rate as the benchmark for NOW accounts.

Section 106(b) would "grandfather" from the bill's ceiling for NOW accounts all depository institutions in New England and New York, even those that do not at present offer NOW accounts. We favor the grandfathering, but we believe that the provision should be more tightly drawn and limited to some temporary duration, such as 2 years.

DEREGULATION OF INTEREST-RATE CEILINGS

Finally, Section 107 would provide for interest-rate deregulation, a goal I strongly support. Section 107(a) would freeze existing Regulation Q ceiling rates and, beginning January 1, 1982, Section 107(b)(1) would require the agencies to raise Regulation Q ceilings by at least one-quarter percentage point every 6 months through July 1, 1989. Under Section 107(b)(2), the Federal Reserve, after consulting with the other agencies, could postpone any semi-annual increase if it finds a serious economic emergency to exist. Likewise, under Section 108, the Federal Reserve, after similar consultation, could reimpose Regulation Q ceilings for periods up to 1 year under similar circumstances after Regulation Q authority under S. 1347 expires on January 1, 1990.

I support the thrust of this effort, but I believe that all regulators should have equal authority as under present law and long-standing practice. The important thing is to set a deadline and work toward it. If thrifts can know where interest-rate ceilings will be in the next several years, and if they are given added powers, they can do the necessary planning and make the necessary changes in their portfolio policies and begin to take advantage of their new asset powers.

We note that the Treasury recommends a new definition of the conditions under which interest-rate increases may be delayed. The Treasury suggests a standard incorporating safety and soundness considerations and monetary policy considerations and proposes to make clear that such emergency delays may apply to any maturity, type of institution, or geographical area.

Under Section 107, it is not clear whether one or more of the regulatory agencies may opt for a semi-annual increase exceeding one-quarter percent (the bill mandates an increase of "at least" one-quarter percent) or whether a greater increase may be effected only with the concurrence of the Congress. Section 107(d) requires that any determination by the Federal Reserve that it would be desirable to accelerate the phase-out be reported to the Congress. We believe these provisions should be revised to clearly specify the procedure by which an accelerated phase-out may be achieved.

#### TITLE II -- RESERVE REQUIREMENTS

Title II would require all depository institutions (including nonmember banks, savings and loan associations, and credit unions) to maintain reserves against NOW accounts in ratios set by the Federal Reserve between 3 percent and 22 percent. Such reserve balances could be maintained by nonmember institutions at depository institutions other than the Federal Reserve Banks provided such balances are "passed through" in toto to a Federal Reserve Bank. For a nonmember institution, reserve requirements would be phased in over a 3-year period.

This would be the first time that nonmember institutions -- including banks, savings and loan associations, and credit unions --

would be required to post federally mandated reserves and be subject to the unilateral regulation of reserve requirements by the Federal Reserve. This innovation would bring us very close to the entire area of Federal Reserve membership which is addressed in separate legislation also pending before your Committee.

As I testified on March 27, required reserves could produce a substantial increase in the number of banks joining the Federal Reserve System because banks would feel that if they must post reserves, they might as well take advantage of the other benefits of Federal Reserve membership, including access to the discount window. The Federal Reserve thus could easily find itself with an unintended increase in its bank supervisory work load -- an additional responsibility that would only further detract from the Federal Reserve's primary concern of conducting monetary policy. I know you will have this in mind as you consider the broader question of required reserves. You may well decide that this added burden leads to the conclusion that the Federal Reserve should remove itself from bank supervision.

TITLE III -- MISCELLANEOUS

Title III would give broader asset powers to Federal savings and loan associations by granting them consumer loan authority and authorizing them to invest in commercial paper, bankers acceptances, and corporate bonds, subject to an aggregate limit of 10 percent of assets. The bill would also grant trust powers to Federal savings and loan associations, subject to regulations issued by the FHLBB. We support the bill's provisions in this area. While we are somewhat less sure of the need or desirability for savings and loan associations

to get into the trust business, we would not oppose such authority if Congress considers it advisable.

We note that these enhanced powers in S. 1347 are limited to federally chartered savings and loan associations. State law already grants certain of these powers to mutual savings banks. We are concerned that competitive balance among institutions be maintained.

#### PREEMPTION OF STATE USURY CEILINGS

Title III would also preempt state usury ceilings on mortgage loans by federally insured institutions by repealing such ceilings with a provision that any state may reimpose usury ceilings within a 2-year period.

It is not clear to me that we should be moving into the area of usurping states' rights in such issues as usury ceilings which historically have been the prerogative of the states. Market pressures have forced a significant number of states to amend or eliminate their mortgage interest rate usury ceilings during the past several months. These include the District of Columbia, Georgia, Idaho, Indiana, Iowa, Maryland, New Jersey, New York, South Carolina, South Dakota, Tennessee, Vermont, and Wyoming. Beyond that, Section 303(a)(1), as written, may have the unintended effect of encouraging lenders in search of higher returns to require an interest in real property as security for various other types of loans.

We see another difficulty in the fact that some security instruments automatically extend the security to cover any other obligations of the same borrower. In such cases, all future loans to the same borrower would be exempt from the state usury laws

once the borrower had executed a real property mortgage containing such an open-end provision.

Also, Section 303(b) would give the states 2 years within which to override the Federal usury exemption by adopting a provision of law limiting the rate or amount of interest. This would be unduly restrictive. State law may require that the preempted usury provision, if contained in a state constitution, be reenacted by amendment to the constitution, rather than by simple legislative enactment. You are aware of this problem in recent legislation on usury ceilings in Tennessee and Arkansas. In such cases, 2 years may provide insufficient time. If this provision is enacted, I see no reason for any time limit for reinstatement of a state usury law. This seems to be a matter best left to the states themselves.

CONCLUSION

Mr. Chairman, I appreciate this opportunity to share our views with you.