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FDIC NEWS RELEASE

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A STAFF PROPOSAL FOR A VARIABLE-RATE TIME DEPOSIT TIED TO TREASURY BILL RATES

Excerpt from an Address by

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The unfortunate time lag between general recognition of the need for broader thrift institution powers and legislative enactment at both State and Federal levels has prompted the FDIC to look with a fresh eye at the powers presently available both to you and to us which might be utilized to prevent the steady erosion of deposit funds when significantly higher interest rates are available in the money and capital markets. In that regard, the 7 1/2% four-year certificate is only partially effective, as recent deposit flows demonstrate. It is also expensive -- more expensive, perhaps, than market rates over a four-year period would require. And the more in earnings which is required to pay the deposit costs associated with the ever-increasing volume of these certificates, the less in earnings which will remain for additions to surplus, unexpected losses or future changes in the Q ceilings on passbook savings or shorter term certificates. Homeowners, in turn, over the four-year period may find mortgage rates maintained at higher levels than might be the case if fewer 7 1/2% certificates had been issued.

On the other hand, the 7 1/2% four-year certificate has proved to be popular with a large number of depositors, particularly those who prefer a four-year certificate, with or without the required penalty for early redemption, to a much longer term corporate bond even at a higher yield. But it is obvious, both from last summer's experience and from your present experience, that at least an equal number of thrift institution depositors will opt for a short-term instrument at high yields rather than a four-year certificate, and with each round of disintermediation, such depositors have become more and more sophisticated about the short-term money market instruments that are available to them. Today, as deposit outflows threaten to exceed last summer's disintermediation in both magnitude and duration and with the competition from commercial bank time deposits no longer a significant factor, the principal threat to your deposit stability can be more clearly identified than ever before, namely, the high yields presently available on three-month and six-month Treasury bills and on short-term Treasury notes. The direct relationship between the yields available on these short-term Treasury obligations and your own deposit outflows has been graphically demonstrated by many individual savings banks, particularly those in Boston, New York and Philadelphia, where investments in Treasury bills and notes are both convenient and cheap for the savings bank depositor who has the required minimum to invest.

Yields on short-term Treasury obligations can fluctuate widely over even brief periods of time, as we all know. At the May 6 weekly auction, the average yield for noncompetitive bids on a three-month Treasury bill was 9.04%, but the average yield in February of this year for a similar bill was only 7.06%; in May 1973 it was 6.35% and in May 1972 only 3.72%. The average yield on newly issued three-month Treasury bills for all of 1973 was 7.02% and for all of 1972 was 4.07%. Would it not be better, then, in light of these historical market rates and savings bank earnings, if the thrift institutions of the country could offer a time deposit which fluctuated with the market rates on such Treasury bills and notes rather than being forced to offer only a 7 1/2% certificate to which they would find themselves committed for a full four years?

My associates at the FDIC believe that it may indeed be feasible to offer a variable-rate time deposit tied to short-term Treasury yields which might be more effective than the present 7 1/2% four-year certificate in stemming the outflow of your deposit funds, as well as less expensive to you over the life of the deposit. Such a variable-rate certificate, which would supplement and not replace any of your accounts, might have the following characteristics:

(1) A ceiling rate, specified in accordance with last October's legislation, that would be announced monthly no later than the 24th day of each month, such rate to be effective for the full calendar month immediately following. The purpose of announcing the rate in advance of the first of the month is, of course, to permit appropriate advertising and to inform the public of the new rate prior to any applicable grace days.

(2) A ceiling rate for thrift institutions equal to the average of the approximate yields announced by the Treasury each Monday for noncompetitive bids on three-month Treasury bills during the four or five weekly auctions immediately preceding the establishment of the monthly rate. Thus, the ceiling rate which would have been announced for April of this year would have been 7.71% and for May 8.34%. The commercial bank ceiling rate would reflect a differential similar to that which exists for other time deposits under the present schedule, <u>i.e.</u>, either 1/4 or 1/2 of 1% per annum. While some other

short-term rate or rates could be selected on which to base such a ceiling, our research staff believes the average yield on noncompetitive bids for three-month Treasury bills to be the most publicized, the best understood, and the most readily available on a recurring basis.

Of course, you will readily see that in times of rapidly escalating Treasury bill rates, such as we have had since March 1 of this year, a ceiling rate set in this way will lag somewhat behind actual yields contemporaneously available at the Treasury's weekly auctions, a lag which would be accentuated if the ceiling rate were set only once a quarter. On the other hand, the holder of such a time deposit would benefit from the same lag when yields on Treasury bills turned downward.

(3) A minimum denomination and a minimum maturity specified by Federal regulation. If the precedent of the present 7 1/2% fixed rate certificate were followed, the minimum denomination would be $1,000 and the minimum maturity would be four years.

(4) Possibly, a specified interest rate floor set at some level below the passbook savings rate. Thus, when the ceiling rate as computed above fell below the specified floor, the depositor would be assured in advance that his downside risk would be limited, thereby assisting him in making his initial investment decision. For example, the interest floor under present circumstances might be established at 4.5% per annum, 75 basis points below the regular passbook rate.

(5) The same minimum penalty presently prescribed by regulations for the early redemption of other consumer certificates. Individual banks could, as they can today, refuse to redeem the certificate unless the depositor held the time deposit to maturity or paid a greater penalty.

(6) Interest earned would, of course, have to be calculated and credited on a monthly basis, while present rules relating to the compounding of interest would apply.

I wish to emphasize that the FDIC has not and is not taking an official position as to the wisdom or desirability of instituting this type of variable-rate certificate, nor has it seen fit to refer this specific proposal to the Interagency Coordinating Committee. I raise it today in order to begin a discussion of its merits, both in concept and in detail. Its adoption is by no means imminent, and, in fact, it may not see the light of day at all either in a Proposed or Final Regulation. But if the concept is worthwhile, I would hope that all of the agencies could benefit from your reaction to the details of its implementation. Thus, you may have operational problems with a ceiling rate that would change monthly, rather than quarterly. Or you may feel strongly that the minimum denomination should be \$10,000 -- the minimum required for Treasury bill investment -- rather than the \$1,000 now required for 7 1/2% certificates and designated issues of short-term Treasury notes. Or you may feel that the guaranteed floor on the instrument should be more or less than 75 basis points below the passbook rate in order to increase its attractiveness to depositors or its acceptability to the institution offering the instrument. On all of these points, your individual and collective views would be helpful and informative to ourselves, the Federal Reserve Board and the Federal Home Loan Bank Board. If, later in the summer, such a deposit instrument would seem to be of value, the agencies will then be able to proceed in a much more orderly way than they did last summer.

In concept, a variable-rate certificate such as I have described might provide a depositor tempted to invest in Treasury bills with the benefits of both the high yields available on Treasury bills and a guaranteed minimum rate, plus the convenience of not having to reinvest every three months. The ability to offer a variable-rate certificate account might thus improve your ability to hold or even attract deposits in the face of rapidly rising short-term rates. To the extent it serves this purpose better during such periods than a fixed rate time deposit, more money should be available for housing than under present circumstances. This, in turn, would reduce the need to resort to special financial assistance through the Federal Home Loan Bank system, GNMA and other government programs when widespread disintermediation is under way. These agencies might then avoid adding to the demand for funds in the capital markets when the supply of credit is already limited and interest rates are already high enough to attract so many of your depositors. Moreover, if the experience of the past four years is any guide, your average cost on such a variable-rate certificate, even with a 4.5% floor, would have approximated 5.71% per annum despite temporary periods of very high Treasury bill yields. Finally, a variable-rate certificate might assist thrift institutions in lengthening their deposit maturities and in this respect serve a function similar to the 7 1/2% certificate, but at far less cost.

There are, on the other hand, certain risks involved in a variable-rate certificate pegged to Treasury bill rates. One is that the level of such rates over the next few years may be significantly higher than the historical pattern of the last four years as the Federal Reserve pursues with determination and greater persistence its anti-inflationary policies. But if this occurs, the loss of depositors' funds to the market may also be an accelerating phenomenon without such a variable-rate certificate. Secondly, the establishment of such a certificate carries the risk that there will be a substantial shift not of 7 1/2% certificate money into the new certificate, but of regular passbook money into the new certificate -- a move which would increase your interest cost on such funds without reducing the expense of 7 1/2% certificates. Obviously, the terms of the new certificate should be designed to discourage this kind of a shift of passbook savings money. This is one reason, although not the only reason, why the establishment of an interest floor on the new certificate which is a significant number of basis points below the regular passbook rate may be critically important. Finally, there is the risk that a variable-rate certificate may be too complex for the average depositor to understand and too difficult an account to advertise adequately and accurately. Its marketability, in other words, may be open to question.

It is possible that on reflection and careful analysis, you and we may each conclude that for some depositors and some institutions a variable-rate time deposit tied to the three-month Treasury bill rate is an idea worth pursuing. Others of you may disagree. But I think we in the agencies can well profit by your comments as we react, once more, in the absence of more long-term legislative solutions, to the pressures of disintermediation.

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