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Financial Institutions and the Competition for Lendable Funds

Statement by

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before the

Subcommittee on Financial Institutions
of the
Committee on Banking, Housing and Urban Affairs
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The process of disintermediation, whereby financial institutions lose deposits or potential deposits to nondeposit investments, is again a fact of life for many of the nation's financial institutions -- the fourth time this has happened in eight years. For many investors, deposits lose their attractiveness when significantly higher rates of return are available on nondeposit investments and when this imbalance persists for more than a few months or even weeks. Over the past few months, unprecedented rates of interest have been available on both taxable and tax-exempt instruments and on short-term as well as long-term obligations. These rates reflect the combined effects of the public's expectations about inflation in the future as well as the efforts of the Federal Reserve System to restrain those inflationary expectations. For depositary institutions, the problems of high interest rate periods are compounded by the lower rates of interest allowed to be paid under Regulation Q on deposits of less than $100,000 and by the deficiencies in earnings power which afflict the nation's thrift institutions and largely determine the levels at which ceiling rates are set for both commercial banks and thrift institutions.

Temporary, stopgap measures are always asked of the Congress when the effects of severe disintermediation, especially on housing and the funds available for home mortgages, are felt. But unless the key issue is tackled, namely the earnings power of the nation's thrift institutions, we will only have more of the same periodically in the future. I know the Subcommittee is aware of this longer term need for reform, even as it grapples with a wide variety of suggestions for more immediate relief from some of the repercussions of our present disintermediation, but the point needs to be driven home and repeated as you face the competing and conflicting claims of those with evident self-interest in the outcome.

Over the years, the nation's thrift institutions and smaller commercial banks have been the principal suppliers of funds for residential home mortgages, with savings and loan associations having the highest percentage of the three types of institutions in total assets committed to residential home mortgages and mutual savings banks the second highest percentage of assets so committed. In the case of mutual savings banks (most of whom are supervised and examined at the Federal level by the FDIC), there can be no doubt that there has been a significant slowdown of incoming funds available for housing investment. Preliminary deposit projections for July indicate record net outflows of funds. Additionally, these banks suffered a net outflow of approximately $350 million last month -- the worst June figures ever recorded -- and of $190 million in May and $645 million in April. Even taking into account interest credited in each of these three months, the funds available for housing investment have fallen off sharply compared to the same months in past years. Savings banks are keeping their liquidity up and their commitments for future mortgage money down as they face continuing deposit drains. In some states, where low usury ceilings may be in effect with respect to residential mortgage loans, the funds available for housing investment are even more limited.

As you know, Regulation Q and comparable provisions of FDIC and FHLBB regulations presently limit the rates of interest which can be paid by most depositary institutions to their deposit customers. Rates of interest on deposits of $100,000 or more are presently unregulated, but passbook savings rates below that amount cannot exceed 5% per annum for commercial banks and 5 1/4% for the nation's thrift institutions. Certificate accounts pay more, depending on maturity and denomination, ranging up to 7 1/4% per annum for commercial bank time deposits of $1,000 or more held on deposit for four years or more and up to 7 1/2% per annum for a comparable thrift institution certificate. Substantial interest rate penalties are imposed if the depositor seeks early redemption. In addition, under the regulations of all three rate-setting agencies, the ceiling rates apply to nondeposit obligations of insured banks and associations unless they fall into certain specified categories, such as a subordinated capital debenture or note of $500 or more which has an original maturity of seven years or more.

As of today, if the underwriting goes forward as planned, Citicorp will issue $850 million principal amount of unsecured notes at an initial interest rate of 9.70% per annum with interest after next June 1 set every six months at 1% per annum over selected Treasury bill rates. Thrift institutions and banks which have already found themselves unable to attract funds effectively in the current high interest rate environment will then face the added competitive challenge of other similar issues which will have undoubted appeal to their traditional depositors.

Citicorp's note is not a deposit, but it will obviously compete with deposits along with other nondeposit market instruments presently available to the public. What makes the Citicorp note look more like a deposit than other market instruments is (i) its relatively low denomination ($1,000 with a minimum subscription of $5,000), (ii) its issuance by a bank holding company whose public identification is synonymous with its principal affiliate, the nation's second largest insured bank, and (iii) its optional redemption features which are available to an investor long before its potential 15-year maturity. While all of these features have a bearing on the competitive threat which some of the nation's depositary institutions see in this type of instrument, it is the early redemption feature at the holder's option which most directly competes with the time deposits that can presently be offered by the nation's thrift institutions and banks.

To illustrate, a time deposit of a mutual savings bank or a Federally insured savings and loan association, issued for the 23 months between now and the earliest permitted redemption of the Citicorp note, could carry a maximum interest rate of 6 1/2% per annum for thirfts and a maximum interest rate of 6% per annum for commercial banks under Regulation Q. Even if the earliest permitted redemption on similar notes were to be four years rather than 23 months, the maximum permitted rate under Regulation Q would be 7 1/2% for thrifts and 7 1/4% for commercial banks.

Under our present regulations, it is only where the earliest possible redemption is seven years away that a thrift institution or a commercial bank would be able to offer a subordinated note whose other terms were identical to those of the Citicorp note. This is because subordinated notes of less than seven years' maturity are deemed to be deposits and are subject to all the interest rate limitations of Regulation Q.

The banking agencies could, of course, react to the "Citicorp note problem" by amending their regulations to provide for a shorter acceptable maturity period on subordinated notes. But with many time deposits bearing maturities in the four- or five-year range, there is only limited room within which the agencies can move if they seek to retain some recognizable difference between shorter-term "deposits" and generally longer-term "capital."

The banking agencies could also permit a variable rate time deposit, with ceiling rates set monthly or quarterly by the agencies in the light of some market indicator of available interest rates, such as the average yield on three-month Treasury bills. In May of this year, I released for comment an FDIC staff proposal along these lines which is now under active consideration by the rate-setting agencies. A copy of that release is attached. This proposal differed, however, in several basic respects from the terms of the Citicorp note issue.

First, the proposed rate of interest on the deposit would be pegged, for mutuals, to the exact average of the yields announced by the Treasury each Monday for noncompetitive bids on three-month Treasury bills and for commercial banks, to a ceiling 25 or 50 basis points below that (the interest rate on Citicorp's note, at least after the first year, would be set every six months at 1% above a selected 21-day average of yields on three-month Treasury bills). Second, the FDIC staff proposed a minimum term for the new deposit of four years, with substantial penalties for early redemption (Citicorp's note, although it carries a 15-year maturity, can be redeemed on June 1, 1976, at par and thereafter at six-month intervals; in addition, a secondary market will exist through listing of the notes on the New York Stock Exchange). Third, the FDIC staff proposed a guaranty that the rate of interest would not fall below some minimum level, such as 4.5% per annum (the Citicorp note carries no floor, but the initial rate of 9.7% per annum is guaranteed until next June 1).

For the public, the critical difference may well prove to be the respective rates at which the proposed time deposit or a note like Citicorp's is initially issued. The FDIC proposal reflected our awareness that the earnings position and potential of the nation's mutual savings banks is limited. We know that the occasional attractiveness of Treasury bills or the challenge of a note issue like Citicorp's cannot be realistically answered by some dramatic, across-the-board increase in deposit rate ceilings under Regulation Q because the earnings of such institutions would not permit the payment, across the board, of the much higher rates that would now be required to attract deposit funds. Even if a limited change under Regulation Q were to be authorized to permit the offering of a variable rate time deposit, such as the one FDIC proposed in May, we know that almost no thrift institution would have the earnings power to pay a 9.7% per annum rate for long on any significant portion of its total deposits.

So in the end, while ameliorative steps can be taken on a temporary, stopgap basis to stem the outflow of funds from housing-oriented institutions, we return to the basic need for increased earnings power on the part of the nation's thrift institutions. Any basic reforms in this area must, of course, be adopted with an eye to their effect on the funds available for housing and home mortgages, and then sufficient time must be provided thereafter for the implementation of such new powers. But we will not escape the repeated crises of disintermediation until such long-range steps are taken.

The proposed Financial Institutions Act represents one such approach to long-range reform. It would broaden the asset and liability powers of thrift institutions operating under a Federal charter while at the same time making provision for a phaseout of Regulation Q ceilings on a gradual basis -- the objective being to enable management to better serve the needs of its depositors and other customers under a wide variety of economic conditions. The FDIC believes that this objective is commendable and hopes that this Subcommittee will turn its attention to the details of such long-run reform early in the next session of the Congress.