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Statement by

Frank Wille, Chairman
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before the

Subcommittee on Financial Institutions
Supervision, Regulation and Insurance
of the
Committee on Banking, Currency and Housing
House of Representatives

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As I indicated on July 21, the FDIC supports a one-year extension of the statutory authority vested in the Federal Reserve Board, the FDIC and the FHLBB to regulate in a flexible manner the rates of interest or dividends payable by insured banks on time and savings deposits and by members of the Federal Home Loan Bank System on deposits, shares or withdrawal accounts. Such an extension is contained in Title I of H. R. 8024. You are, of course, aware that the FDIC favors the eventual elimination of Regulation Q-type ceilings through legislation like the proposed Financial Institutions Act which would substantially expand the ability of thrift institutions to compete for the savings dollar and put to an end the obvious discrimination which presently exists against those depositors with accumulated savings of less than \$100,000 -- a category which encompasses the vast majority of the nation's citizens. We considered it unrealistic, however, to expect Congressional review and action on the many important and controversial matters related to that legislation to be completed prior to December 31 when the current rate-setting authority expires, and so supported the extension provided for in H. R. 8024.

The Chairman's letter of August 28 expressed concern about the effectiveness of interest ceilings and existing rate differentials, and I would like to comment briefly on some of these issues.

The structure of interest rate ceilings applicable to savings deposits at insured banks and thrift institutions importantly affects their ability to attract deposits. It also importantly affects their profitability

and soundness; the pricing of many banking services, and the flow of funds from one type of insured institution to another and from all intermediaries into housing, job-creating businesses and other sectors of the economy. In setting interest ceilings and drawing up regulations to enforce those ceilings, the Federal rate-setting agencies are confronted with a number of competing, and indeed conflicting, considerations and seek to strike a reasonable and defensible balance between them.

I think it fair to say that the rate-setting agencies have invariably attempted to assess the likely result of their decisions on the returns available to individual savers, on both the short- and long-run implications for insured financial institutions and those portions of the economy served by such institutions, and on various financial markets in which insured institutions may or may not play a significant role. This evaluation may turn out in retrospect to have been incomplete or wrong, but I can assure you an interagency effort is made to appraise carefully before we act the likely consequences of specific actions. Few decisions involving rate ceilings or the regulations which implement them impact favorably on everyone, however, and they may be made in anticipation of market developments rather than subsequently. For these reasons, among others, our rate decisions are among the most sensitive and controversial we make.

Generally speaking, rate ceilings have tended to work in a satisfactory manner so long as their levels have been not too far out of line with market rates. The past six month period probably provides a good example

of this. However, when market rates move up sharply, as they have on several occasions during the past ten years, the establishment of appropriate rate ceilings becomes more difficult and some real enforcement problems emerge. At such times aggressive institutions have been constrained from paying higher rates, and as a result, they have lost funds to market instruments. Smaller depositors, either because of limited resources or lack of financial sophistication, have received far lower returns on their funds than they could on alternative market investments. At such times, institutions with limited portfolio flexibility, limited earnings capabilities and limited capital funds and reserves have been particularly vulnerable to significant deposit outflows and lower annual earnings. If, however, rate ceilings are not revised upward under such circumstances, disintermediation may be exacerbated and the deterioration in current and retained earnings aggravated by the need to maintain a higher than normal degree of liquidity, particularly if forced sales of assets and possibly significant capital losses are required.

Additionally, whenever rate ceilings have significantly impaired the ability of insured institutions to compete against an open market rate structure for the savings dollar, the incentives for circumventing rate ceilings increase proportionally and effective enforcement of the spirit and intent of Regulation Q-type ceilings becomes more and more difficult. In the past, this has led to a tightening of the definition of deposits subject to the ceiling; to get at short-term notes; to tougher prepayment penalties to discourage

redemption of certificates -- and the payment of even higher rates -- prior to maturity; and to increased surveillance of institutional "pooling" arrangements and deposit advertising.

Since 1966 ceilings on consumer deposits have been set at higher rates for thrift institutions than for commercial banks. The rationale for this differential has been principally to assure a satisfactory flow of funds to savings and loan associations and mutual savings banks and from these institutions to the mortgage market. In periods of rising interest rates, average returns on thrift institution portfolios, which are dominated by assets carrying long maturities, tend to lag behind market rates. As a result, the competitive position of thrifts, at such times, tends to deteriorate vis-a-vis commercial banks. Rate ceiling differentials were originally intended to insulate thrifts, to some degree, from commercial bank competition, the rationale for such protection resting principally on matters of product line and resulting asset structures. Since commercial banks offered a wider range of services, including checking accounts, and could generally afford to pay higher rates on deposits than thrifts in periods of rapidly escalating market rates (because of a more flexible asset structure), it was argued that a differential was necessary to assure an adequate flow of funds into thrift institutions and from them to the mortgage market. I believe the differential also reflected a feeling in 1966 that thrift institutions were relatively vulnerable to earnings pressure resulting from an upsurge in rates they had to pay on deposits and needed time for appropriate portfolio adjustments to improve

their earnings performance before being subjected to greater commercial bank rate competition.

In recent years, the permissible powers of thrift institutions have expanded considerably. Some of this has taken place at the Federal level for federally chartered savings and loan associations and credit unions, but even more has taken place at the State level, particularly in New England, for state-chartered thrifts including mutual savings banks. With developments taking place at unequal rates of speed at Federal and State levels, it is only natural to expect increased commercial bank pressure to revise the basic ground rules of deposit competition presently found in Regulation Q and its FDIC and FHLBB counterparts. They argue now, and will no doubt continue to argue in the future, that the expanded asset powers and liability services of thrift institutions make them able to compete with commercial banks on a relatively equal footing and that it is more and more inequitable to maintain the differentials as they are.

In this climate, it seems to me that the rate-setting agencies have an obligation, subject to any specific action the Congress may take on either deposit rate ceilings or the more basic question of asset and liability powers for insured institutions, to review the fairness to savers of existing levels of deposit rate ceilings, the underlying reasons for rate differentials between thrift institutions and commercial banks, the experience of the past as to whether ceilings and differentials have actually accomplished their intended purposes, and the likely course of market and institutional developments both in the short run and the long run. Numerous, interrelated factors are involved

in the complex business of administering a system of deposit rate ceilings, as this Committee undoubtedly recognizes through its FINE study and its consideration of legislation like the proposed Financial Institutions Act. All three rate-setting agencies take their responsibilities with the utmost seriousness, and I am sure this attitude will continue to prevail.