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THE SURGE IN BANK SAVINGS - ROSE WITH THORNS

Remarks of C. Canby Balderston,

Vice Chairman, Board of Governors of the Federal Reserve System,

at the District of Columbia Bankers Association Convention,

White Sulphur Springs, West Virginia,

Thursday, June 13, 1963.

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Commercial banks have been on the move competitively. This competitive spirit is manifested in various ways, ranging from the well-advertised urge to merge and branch to the many new services provided to attract and keep valued corporate accounts.

But the aspect of competition I wish to discuss is the dramatic drive by banks to acquire savings and other time deposits. This drive has been especially notable since the beginning of last year, when Regulation Q restrictions were altered to permit maximum rates on time deposits of as much as 3-1/2 per cent for ordinary accounts and 4 per cent for one-year money. The speed with which the newly permissible higher rates were adopted indicates that many banks felt that the protective cloak of Regulation Q had been detrimental to their competitive welfare.

Once free to pay the higher rates of interest, banks found themselves the recipients of a vastly enlarged flow of savings funds. Whereas their savings and time deposits had been growing at an average annual rate of about 9 per cent over the previous decade, the increase last year amounted to 19 per cent. And for District of Columbia banks, the 1962 expansion in such deposits was even larger--21 per cent.

The response of savers to the higher rates must have been gratifying to you; it reflects the fact that, over the years, banks have given their savings customers an increasingly better deal. Interest rates, which were typically 1 or 1-1/2 per cent not so many years ago, have been raised successively to the point where the majority of depositors are now eligible to receive 3-1/2 or 4 per cent. Currently, 45 per cent of the Federal Reserve's member banks pay these rates on savings accounts, and these banks hold more than three-fourths of such deposits. On other time deposits, 73 per cent of the member banks pay a maximum rate of either 3-1/2 per cent or 4 per cent. The bases for interest computation have been liberalized also; where interest used to be computed semi-annually on minimum balances during the period, it has become common now to compound quarterly on daily-average balances. Furthermore, a wider variety of savings instruments is being offered by banks to meet customer needs. Time deposits, as contrasted with passbook savings accounts, have become increasingly important; and since early 1961, more than $6 billion of negotiable time certificates of deposit have been issued by the nation's leading banks. This is essentially a new type of money-market instrument, competing directly with other negotiable securities such as Treasury bills and commercial paper.

The impact of all of these changes on bank deposits may be measured in two ways. In terms of dollars, time and savings balances at commercial banks rose more than $25 billion in 1961 and 1962. This was more than in the previous five years combined. In terms of their share of the savings-account market, such banks accounted for 51 per cent of the 1961-62 growth of the three major kinds of deposit-type savings institutions, as compared with 37 per cent in the preceding five-year period. Meanwhile, demand deposits rose only $4.2 billion in 1961 and $1.4 billion in 1962, partly reflecting the pull of higher savings rates on idle demand balances. Despite this internal competition, however, it seems apparent that the ability of banks to attract savings funds was considerably enhanced.

Now that a year and a half of higher interest rates on savings has passed, it is time to take stock not only of the gains to the nation's economy but of the risks to the banks. In my view, it is appropriate for the officers of every bank to recheck its individual position and its direction of movement. But you should be warned as to my bias in these matters: I tend to the philosophy that the time to fix the roof is when the sun is shining. A banker does not knowingly make bad loans or investments--they just become bad afterward.

Looking back at the decision of the Board of Governors through the knot-hole of June 1963, I view the change in Regulation Q as one of the most important monetary actions that the Board has taken in recent times. Not only has it freed banks to compete, but it has also brought important shifts in the investment markets. It should be observed that some of these were not anticipated because the rush of banks to avail themselves of their new liberty was quicker and greater than had been foreseen. One important corollary result was to divert corporate demand away from Treasury bills and, by helping to maintain bill rates, to discourage the outflow of short-term funds to other countries. Another was to encourage the banks to seek longer-term loans and investments, bringing downward pressure on interest rates on both bonds and mortgages, with whatever spinning action this movement may have imparted to the economic wheel.

So much for the roses that have bloomed on the new deposit growth. I turn now to the thorns that need to be guarded against, some of which may be hidden. The most obvious of the thorns is that the interest expense of the banks has soared. Just since 1956, the interest costs of member banks have almost quadrupled as both time-deposit balances and average interest rates paid have about doubled. The latter rose from 1.6 per cent to 3.25 per cent. The increase last year was especially dramatic, reflecting the widespread boost in advertised rates, and amounted to $630 million or 37 per cent.

Despite these soaring costs, member bank managements were able to maintain net current earnings before taxes at about $3.1 billion in 1962. But this was accomplished, as is well known, by a pronounced shift in the mix of earning assets toward longer-term higher yielding investments. Herein rests the possible hidden thorn, since the price of exposure to greater risk and less liquidity is yet to be assessed, but suggests attention to the adequacy of capital and reserves.

I shall not mention last year's increase in the business and consumer loans extended by banks, except to remark that this was perhaps more a reflection of cyclical economic expansion than of any deliberate new effort to increase market penetration.

To get mortgages, though, banks really stepped up their competitive activity; last year, their mortgage holdings expanded by a record $4 billion. Naturally these credits were essentially long-term in nature, and professional worriers may hope that overly optimistic appraisals will be counteracted by steady amortization. In any case, those interested in construction and in financing existing properties have had the boon of falling mortgage rates.

Another greatly enlarged form of investment by banks has been that in municipal bonds. Last year, banks took $4.4 billion or 80 per cent of the expansion in State and local debt. Indications also are that they were important buyers of relatively longer maturities as well as of the short and intermediate ones. Mainly as a result of this heavy bank demand, the composite tax-exempt yield dropped from 3.63 per cent to 3.22 per cent. Clearly, cities and other local units of government gained as a result. One old enough to remember the 1930's may wonder whether banks would find a ready market for some of these issues, especially the small ones, if many holders were to decide simultaneously that they wished to sell them. Far from predicting such trouble, I would counsel its prevention through attention, in each bank, to balance and proportion.

Finally, I turn to the only major category of earning assets in bank portfolios that did not increase last year--securities of the Federal Government. The drop of $400 million followed an increase in holdings of $5.6 billion the year before. More noteworthy still was the marked extension, last year, of maturities held. Doubtless this reflected the advance refundings by the Treasury, but the important point for this discussion is the impact upon bank liquidity. Last year, bank holdings of maturities three years and under fell by more than $10 billion; those from 3 to 10 years, rose almost $12 billion. And so bank officers clearly have shifted their portfolio distribution in the direction of longer-term securities with potentially more volatile market prices.

The response of District of Columbia banks to increased inflows of funds last year was similar to, though less pronounced than, the national pattern. Unlike the national performance, holdings of U. S. Government securities by District banks rose moderately in 1962, as they had in 1961. But holdings of short-term Governments were reduced, while intermediate-term ones were increased; yet both of these changes were less marked than those in the national figures. Holdings of mortgages rose 19 per cent, as against 13 per cent nationally, and, from a relatively small base, those of State and local securities jumped 29 per cent. Thus, District banks, too, have made important portfolio adjustments that have lengthened the average maturities of loans and investments.

Inferences

My purpose is not to question the wisdom of bank management decisions as reflected in these investment portfolio shifts. I merely suggest that the time has now come for bank officers to assess their positions. How stable are the new time deposits, many of which were attracted by an interest rate appeal during a period of relatively low market yields? Are liquidity reserves ample to take care of certificate of deposit maturities that are bunched on tax dates? What has happened to loan quality in the rush to put additional amounts of higher yielding assets on the books? Has sufficient provision been made to meet the probable credit needs of customers in the period ahead? Have investment acquisitions unduly shifted portfolio balance in relation to long-term objectives?

These are not questions appropriately answered by a central banker; rather they are the responsibility of the investment committee of every commercial bank. Investment actions have reduced liquidity substantially, and further movement in this direction could jeopardize future banking operations. The problem, of course, is to achieve the optimal balance between aggressive service and prudent liquidity; between the costs of additional deposit funds and the yield on them from suitable loans and investments. But to state the problem is not to solve it. That must be left to the experience, logic and good sense of each bank management.

Appendix to The Surge in Bank Savings--Rose With Thorns *

Table 1

Net Increase in Time and Savings Deposits, 1957-62

	Three Major Institutions* (billions of dollars)	Commercial Banks: Net Gain (billions of dollars)	Commercial Banks: Percentage Increase	Commercial Banks: Percentage of Market
1957	12.0	5.6	11	46
1958	15.4	7.0	13	45
1959	9.9	2.0	3	20
1960	14.4	5.5	8	38
1961	20.0	9.2	13	46
1962	28.1	15.5	19	55

* Commercial banks, mutual savings banks and savings and loan associations.

Table 2

Expense Factors of Member Banks, 1956-62

	Total Expenses (millions of dollars)	Interest on Time Deposits (millions of dollars)	Average Rate on Time Deposits (per cent)	Total Time Deposits (End of Year) (billions of dollars)
1956	3,680	650	1.58	42.2
1957	4,222	927	2.10	46.5
1958	4,617	1,123	2.24	53.3
1959	5,140	1,280	2.36	54.2
1960	5,655	1,434	2.61	58.9
1961	6,074	1,720	2.73	67.5
1962	7,041	2,358	3.23	80.1

Table 3

Net Increase in State and Local Government Securities, 1957-62

	Total (billions of dollars)	Commercial Bank Holdings: Amount (billions of dollars)	Commercial Bank Holdings: Per Cent Increase	Commercial Bank Holdings: Per Cent of Market
1957	4.6	1.0	8	22
1958	5.6	2.6	19	47
1959	4.7	0.4	3	9
1960	3.7	0.6	4	16
1961	5.1	2.8	16	54
1962	5.5	4.4	22	81

These charts were prepared by Messrs. J. Charles Partee and Richard C. Pickering of the Board's staff as background for talk before the District of Columbia Bankers Association Convention at White Sulphur Springs, West Virginia, on June 13, 1963, by C. Canby Balderston, Vice Chairman, Board of Governors of the Federal Reserve System.

Table 4

State and Local Security Yields

	December 1961	December 1962	Change (basis points)
Moody's Composite	3.63%	3.22%	- 41
New Aa issues (IBA):			
1 year	1.60	1.60	0
5 year	2.40	2.05	- 35
10 year	2.90	2.50	- 40
15 year	3.25	2.75	- 50
20 year	3.45	3.00	- 45
30 year	est./3.60	3.33	- 27

Table 5

Net Increase in Mortgage Debt

	Total (billions of dollars)	Commercial Bank Holdings: Amount (billions of dollars)	Commercial Bank Holdings: Per Cent Increase	Commercial Bank Holdings: Per Cent of Market	FHA Secondary Market Yields (December) (per cent)
1957	12.1	0.6	3	5	5.61
1958	15.3	2.2	9	14	5.60
1959	19.0	2.5	10	13	6.23
1960	16.2	0.7	2	4	6.04
1961	18.4	1.6	6	9	5.71
1962	24.6	4.0	13	16	5.53

Table 6

Net Increase in Commercial Bank Holdings

	Instalment Credit: Amount (billions of dollars)	Instalment Credit: Per Cent	Business Loans: Amount (billions of dollars)	Business Loans: Per Cent
1960	1.4	9	2.9	7
1961	0.3	2	2.1	5
1962	1.9	11	3.9	9

Table 7

Net Changes in Bank Holdings of U. S. Government Securities

	1961 (billions of dollars)	1962 (billions of dollars)
Under 1 year	+7.1	-2.4
1 - 3 years	+1.0	-8.0
3 - 5 years	-1.9	+4.7
5 - 10 years	-0.5	+7.0
Over 10 years	-0.2	-1.7
Total	+5.6	-0.4